



GEORGIA FISCAL ASSESSMENT

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This assessment of the fiscal situation in Georgia was conducted at the request of USAID/Tbilisi under Contract No. 114-C-00-03-00143-00, Supporting the New Government of Georgia – Ministry of Finance. The field work for this assessment was conducted over the period of January 31 to February 12, 2005 by a team of professionals from BearingPoint, Inc. that included: Khwaja Sultan (macroeconomic and fiscal policy), Gareth Davies (tax and customs administration), Doug Brown (budgeting), John Yates (information technology), Ken Cahill (pension), Fran Greaney (Project Manager) and Tina Anderson, with support from the local professionals on the project team and USAID/Tbilisi. The assessment was conducted based on review of relevant laws and other background documents and extensive interviews with government officials, other donors and technical assistance providers and the private sector.

Abbreviations

MoF – Ministry of Finances

MoLHSA – Ministry of Labor, Health and Social Assistance

SUSIF – State United Social Insurance Foundation

GISSS – Georgia Insurance State Supervision Service

WB – World Bank

EU – Delegation of European Commission to Georgia and Armenia

MCG – Millennium Challenge Georgia

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EXECUTIVE SUMMARY

1. OVERVIEW

This fiscal assessment was conducted in Georgia between the 31st of January 2005 and the 12th of February 2005. The assessment focused on the following key areas with regard to the Georgian Government's capacity in fiscal policy formulation and administration:

- Macroeconomic and Fiscal Policy
- Tax Policy and Revenue Administration
 - Tax Policy
 - Tax Administration
 - Customs Administration
- Public Expenditure Management
 - Budget Preparation
 - Budget Execution
 - Internal Audit
- Pension Reform
 - Structure of the Pension System
 - Administration of Contributions and Benefits

This assessment is structured to provide a brief background analysis of the current situation for each of the above-mentioned key areas, and then presents recommendations for future reform initiatives and possible donor assistance.

2. BRIEF BACKGROUND

The Georgian economy has achieved robust growth in the last few years, with 8.5% growth in GDP in 2004. GDP growth is expected to average 5% over the next 4 years fueled by growth in telecom, financial services and BTC pipeline transit revenues. The rate of inflation is expected to stay low, averaging 5% over the next four years.

Preliminary results show tax revenue rising from 14.6% of GDP in 2003 to over 19% of GDP (based on preliminary data) in 2004.

Most budget arrears (wages, pensions) were paid off in 2004 and the remaining balance will be cleared off in 2005. Recent moves to double the basic labor and social pension, along with the reduction in the social tax contribution rate, have not been analyzed for long-term impact and the impact should be carefully monitored.

USAID technical assistance has made positive and significant contributions to the modernization of Georgian fiscal institutions over the past several years. These include:

- Restructuring and automation of the Tax Department
- Establishment of a Ministry of Finance Training Center
- Establishment of a Parliamentary Budget Office
- Development of Ministry of Finance personnel – numerous professionals who participated in prior USAID projects now hold key positions in the Ministry of Finance and its subsidiary departments

3. RECOMMENDATIONS

Presented below are the key areas of recommended focus for support of Georgia's continued fiscal reform agenda and the accompanying policy reforms and institutional development.

Macroeconomic and Fiscal Policy

- Strengthen the institutional capabilities of the Ministry of Finance and its subsidiary departments, the Ministry of Economic Development and the Parliamentary Budget Office to formulate and implement sound economic and fiscal policies.
- Provide training to MoF staff in economics of taxation, tax policy and revenue analysis tools including micro-simulation analysis.
- Develop human resource function and plan to deepen staff capability.
- Conduct a review of the revenue dynamics and suggest adjustments and remedial measure in the Budget for the Government.
- Improve economic and fiscal databases, including development of database from tax return data that could be used for impact analysis.
- Design detailed Budget documents.
- Strengthen the Budget Committee of Parliament's fiscal policy analysis capabilities.

Tax Policy

- Review of the Tax Code, to revise a number of policy issues.
- Review and revise administrative provisions of the Tax Code to clarify and minimize the compliance burden on taxpayers.
- Develop a fully integrated land information system with a fiscal cadastre.

- Create a modern land information system.
- Build capacity in property valuation.

Tax Administration

- Development of Revenue Analysis Units that produce risk assessments for compliance needs of audit, collections, and refund (particularly with regard to exporters).
- Re-engineer business processes to reduce administrative burden and utilize systems to electronically submit required documentation.
- Strengthen taxpayer education program – training, brochures, internet access. Introduce administrative consolidation of tax and customs functions.
- Strengthen functional organization through technical assistance to institutionalize the key functions of audit, collections, taxpayer service, appeals and legal, through training, performance measurement, and improved management controls.
- Develop human resource strategic plan to address employee retention and capacity building through training, job descriptions development, performance measurement and compensation.
- Add a case-tracking module to track arrears, manage collection processes, and audit function.
- Identify risk criteria, provide advice on VAT administration, and develop a robust refund processing system.
- Development of management information system for better data sharing and upgrade Tax Department's human resources system.
- Provide IT technical assistance in advisory services, hardware, software, and training.

Customs Administration

- Redraft the Customs Code to comply with the Kyoto Convention (revised).
- Implement the Harmonized System for tariff classification.
- Strengthen implementation of GATT Article VII Agreement on Customs Valuation (ACV) -implement specialized valuation division.
- Implement customs bond/guarantee program with an effective management system to ensure revenue protection for all suspension regimes and for periodic accounting.
- Implement 'Post Entry Verification' (customs audit); implement risk assessment for export shipments and to eliminate 100% examination on import.

- Implement a licensed, bonded customs broker program.
- Implement the 'Development Strategy of the Customs Department' for development of human resources.
- Procure hardware, software, and equipment for the central data processing center to ensure reliability of ASYCUDA.

Budget Preparation

- Improve Investment Budget analysis and process.
- Enhance Budget documents, public education and outreach relative to budget process.
- Strengthen capability of Parliament Budget Committee—stronger analytical capabilities; counterbalance to strong executive role.
- Develop integrated Budget Information System in connection with FMIS implementation.
- Strengthen ability of Ministry of Finance and line Ministries in program budgeting as key supplement to MTEF initiative.
- Strengthen ability of non-pilot Ministries in MTEF process for 2nd year of rollout.

Budget Execution

- Implement a Government FMIS--to include core financial modules, with capability to phase-in other modules.
- Restructure operations for pension distribution and accounting in support of Government pension reform initiative.
- Upgrade communications between center and regional treasuries.

Internal Audit

- Educate Ministry of Finance and other Ministries on important role that Internal Audit can play in financial management and governance.
- Develop Internal Audit unit in the Ministry of Finance, with a government-wide coordination role.
- Develop institutional capacity of Internal Audit units in all key ministries to develop IA units, bringing them up to international standards.

Pensions

- Consider more fundamental pension reform that links contributions with benefits, provides incentives for retirement savings, etc. and conducting analysis of fiscal impact on any reforms (but short-term and longer-term).
- Support Working Group to consolidate and simplify the laws governing pensions, under the current system and with an eye toward implementing broader reforms.
- Strengthen the institutional capacity of ISSS in order to effectively supervise the private pension industry, including training, investment regulations, reporting requirements, etc.
- Develop system for tracking contributions by individual.
- Unify pension databases of current and future beneficiaries.
- Add functionality to track pension contributions and calculate pension benefits for individuals.

**OVERVIEW OF GEORGIA'S ECONOMIC
AND FISCAL SITUATION**

1. BACKGROUND

The South Caucasus, in which Georgia is located, is a kind of “hinge” between Europe and Asia, the Orient and the Occident”.¹ As such, the region faces a vast array of security, economic and political challenges, some reminiscent of the Soviet times, some related to the transformation from the Soviet system. The region remains shrouded in a high degree of strategic uncertainty, and unsettling domestic trends— such as criminality and corruption, flourishing drug and arms trade, ethnic and religious issues, refugee crisis and impending environmental disasters. The nature of the region’s problems requires not only increased attention from the global community, but also a concerted response on behalf of Georgia, Armenia and Azerbaijan. Given their geographic location, the Caucasus countries have become more important as security allies in the campaign against terrorism

Georgia’s per capita GDP stands at US\$ 1,131, which places it at the low-middle income countries. A little more than 50 percent of the population lives below the minimum subsistence level of \$ 1 a day, and about 15 percent of the population lives in extreme poverty. Minimum wage used to be GEL 20 (\$10) per month, but has now increase in the end of 2004 to GEL 115 (\$ 65). In a population of 5 million, there are 900,000 pensioners, who until recently were getting pensions of GEL 18 (\$ 9). These have been raised to GEL 28 this year.

Georgia has benefited considerably from international assistance. Partly, with the help of international assistance, but also because of democratic changes and economic reform efforts that have been ushered by the velvet revolution in November 2003, the Georgian economy has achieved robust growth in recent years, with 8.5% growth in GDP in 2004. GDP growth is expected to average 5% over the next 4 years fueled by growth in telecom, financial services and BTC pipeline transit revenues. The rate of inflation is expected to stay low, averaging 5% over the next four years.

The economy is undergoing structural change with foreign inflows coming from remittances, privatization, and donor funding. As a result, there has been a gradual remonetization of the economy and a strengthening of the lari. Thanks to a drive to curb evasion and corruption, tax revenue have risen from 14.6% of GDP in 2003 to over 19% of GDP (based on preliminary data) in 2004. Most budget arrears (wages, pensions) were paid off in 2004 and the remaining balance will be cleared off in 2005.

2. RECENT REFORM INITIATIVES

¹ Martin Malek, “Terms of Reference of Security Policy in the South Caucasus,” *Mezhdunarodnaya Zhizn*’

Since the inauguration of President Shakalishvili in early 2004, the Government of Georgia has undertaken an ambitious economic reform agenda much of which is anticipated to have a positive impact on the economic and fiscal performance in Georgia, both in the short-run and in the longer-term. A few examples of some of the most significant reforms, from a fiscal perspective are the following:

- Consolidated seven Ministries under the Ministry of Economic Development;
- Renewed the privatization program, which is anticipated to have both a significant positive impact on economic restructuring and on the government budget;
- Took aggressive action against tax evaders, forcing many taxpayer to increase tax payments and took criminal action against a number of them;
- Enacted a new Tax Code that reduced the number of taxes to eight (including customs duties) and
 - Reduced the VAT rate from 20% to 18% (from July 2005),
 - Reduced the income tax to a flat rate of 12%,
 - Reduced and consolidated social tax contributions from 33% to 20%, and
 - Significantly increased excise tax rates
- Consolidated district tax offices from 79 to eleven;
- Established new provisions in the Budget System Law that prescribed the use of the Medium Term Expenditure Framework in the government's budgeting; and
- Appointed young reform minded officials to senior positions in the Ministry of Finance, Ministry of Economic Development, Tax Department and Customs Department.

These actions provide some evidence of the Government's determination to undertake significant reforms to their fiscal system. It also sets the stage for continued progress and deepening of reforms as the critical fiscal institutions are restructured under new leadership.

Former Minister of Finance (now Prime Minister), Zurab Nogaideli, had set out his priority in the area of fiscal reform, which included:

- Financial Policy (really fiscal policy)
- Tax Department
- Customs Department
- Budget system
- Treasury system
- Financial Police

With these broad areas in mind, the assessment team undertook a review of the current situation and identified specific area requiring attention and reform, either from a policy or an operational (institutional) perspective.

3. CURRENT AND PLANNED TECHNICAL ASSISTANCE ACTIVITIES

Given the importance of strengthening fiscal performance in Georgia, it is not surprising that a number of donors are either currently providing assistance or are planning to provide assistance to the Government of Georgia in this general area. The types of planned assistance ranges from material support or financing for acquisition of computer hardware or software, to the provision of technical assistance and/or training.

In some cases, the assessment team was able to obtain fairly detailed information on other donors' activities. In other areas, particularly where these activities were in the planning stages, the team was only able to obtain information about the broad areas of intended work. Presented below is a brief summary of other technical assistance activities, based on the information that the team was able to obtain either through direct interviews with donor agencies or through documentation of the planned assistance activities (see Appendix 1)²:

3.1. Macroeconomic Analysis

- **EU (TACIS)** (Jan 2005 – June 2005) is providing short-term assistance to update a macroeconomic model originally developed under USAID's earlier fiscal reform project.
- **IMF** (since 1996) is providing technical assistance in price statistics.
- **World Bank (Kennedy Statistics)** (since 1996) is providing assistance in national income accounts.
- **DFID** (2001) is providing assistance in social trends.

3.2. Tax Policy/Administration

- **USAID** (Oct 2004 - Nov 2005) is providing technical assistance to the Ministry of Finance to strengthen tax administration (see Appendix 1).
- **US Treasury** (ongoing through June 2005) is providing assistance through short-term and medium term advisors (including Chuck Stromme) focusing on collections and taxpayer registration. Tom Simpson, a US Treasury Tax Advisor, just completed an assessment to assist UST in planning its future activities in the tax area (the output of this assessment was not available to the team).

² This table of planned assistance for the Ministry of Finance was provided by Hennie Maters as a summary of the outcome of a Donor coordination meeting on November 8th, 2004. See also, report entitled "Achievements of Ongoing Reforms and Urgent Financing Priorities," produced by Hennie Maters for discussion at the donor meeting. Coverage or planned activities, level of funding and timing of assistance are all subject to change depending on final decisions by donors.

- **EU (TACIS)** (plan for June/Sept 2005 - June/Sept 2007) will provide assistance in tax administration training and improving taxpayer service.

3.3. Customs Administration

- **US Government** through the US Border Control Agency of the Department of Homeland Security is providing material support and training for new equipment for the border posts.
- **EU (TACIS)** is providing assistance in drafting a new Customs Code and is planning for a new activity (June/Sept 2005 to June/Sept 2007) to provide assistance with subsidiary legislation as well as training. This activity is currently under review due to delays on the part of the Georgian Gov't in moving ahead with the Customs Code that the prior EU assistance developed.

3.4. Budgeting/Medium Term Expenditure Framework

- **DFID** – (Nov 2004 to ??) plans to provide technical assistance and support to the “Secretariat” of the MTEF Task Force in the Ministry of Finance.
- **World Bank** is providing technical assistance to Ministry of Education: current TA (Harvard University) for General Management Support and to develop new Education financing models, but this is not likely to help MTEF process directly; WB considering a new TOR to support MTEF, but this is still tentative.
- **EU (TACIS)** is providing technical assistance to the Ministry of Agriculture to support MTEF process—18 months, 1 million Euro.
- **US Treasury** (starting March 2005) will provide a resident Budget Advisor (Jason Orlando) to the Ministry of Finance to support the MTEF.

3.5. Budget Execution / Treasury

- **IMF** (starting March 2005) will provide a resident Treasury Advisor (John Zorab) to assist the MoF with the implementation of the IMF's Government Finance Statistics (GFS) chart of accounts, version 2001.
- **EU/GTZ** (according to Chuck Stromme, UST Tax Advisor), the German Government is planning to assist the Chamber of Control with \$1 million of TA.

3.6. Pension Reform

- **World Bank** provided limited technical assistance to support prior pension policy discussion and development of new laws. Currently, there is an

assessment underway to determine future WB support in the pension area. At this time it appears that the support would be limited to capacity building to improve the ability to analyze the impacts of pension reform scenarios.

- **USAID** is providing some technical assistance to the State Unified Social Insurance Fund (administrative responsibility for pensions, health and employment benefits) through its Health Care Reform. The TA seeks to improve the organizational performance of the SUSIF, though the assistance is confined to the agency's health responsibilities.

FISCAL ASSESSMENT

1. MACROECONOMIC AND FISCAL POLICY

The Georgian economy has achieved robust growth in the last few years, with 8.5% growth in 2004. The current per capita GDP is US\$ 1,131. Growth is expected to average 5% in the next four years, fueled by the construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline, and increased activity in telecommunication and financial services. The economy is going through a massive structural change with foreign inflows coming from remittances, expected privatization, and donor funding. There has been a gradual remonetization of the economy and a strengthening of the lari. Inflation has remained modest and is expected to remain under 5% in the next four years. Expansion in liquidity has been kept under check with the National Bank of Georgia (NBG) sterilizing money. Georgia has received strong support from donors, mainly the World Bank, the United States and the EU. Also, the US Millennium Challenge Corporation (MCC) is expected to consider a request for a sizeable grant.

Unlike in previous years when there were chronic shortfalls in meeting budget revenue targets, the year 2004 showed impressive overall fiscal performance. Preliminary results show tax revenue rising from 14.6% of GDP to over 19% of GDP. Tax revenues increased by 55% year-on-year, while non-tax revenues almost tripled³, both results were significantly higher than initial and revised targets for the year. Most major sources of revenue increased significantly as a percentage of GDP. The one-time increase in non-tax revenue was mainly due to fines collected by the Prosecutor General from former government officials suspected of corruption. Tax revenues improved largely due to improved administration and concentrated effort against tax evasion⁴, and the re-annexation of Adjara region (which has led to reduced smuggling and increased customs and VAT revenue at the border with Turkey). The table below shows the increase in main revenues as a percentage of GDP between 2003 and 2004.

As a result of strong revenue figures compared to a deficit of 2.1% of GDP in 2003, there was an overall surplus in 2004. On the strength of the over-performance in revenues, appropriations for defense, energy and internal security were increased, and domestic arrears (including those of wage and pension) were reduced from a stock of 419 million GEL in the end of 2003 to 170 million GEL in the end of 2004. Budget for 2005 projects complete clearing of these arrears.

³ Revenues for 2004 are compiled from data from the Treasury Department while that for 2003 are compiled from NBG data.

⁴ There has been a significant increase in sales declared by enterprises.

Table 1. Comparison of Main Revenues as % of GDP for 2003 and 2004

| Title | 2003 | | 2004 | |
|---|--------------|-------------|--------------|-------------|
| | m Gel* | % GDP | m GEL | % GDP |
| Nominal GDP** | 8,561 | - | 9,800 | - |
| Tax Revenues | 1,250 | 14.6 | 1,930 | 19.7 |
| Income Tax | 152 | 1.8 | 268 | 2.7 |
| Profit Tax | 101 | 1.2 | 161 | 1.6 |
| VAT | 415 | 4.8 | 628 | 6.4 |
| Excise Tax | 106 | 1.2 | 163 | 1.7 |
| Customs Duties | 70 | 0.8 | 100 | 1.0 |
| Other Taxes | 128 | 1.5 | 134 | 1.4 |
| Tax to Unified Social Security Fund(Social Tax) | 222 | 2.6 | 400 | 4.1 |
| Taxes to the State Road Fund | 52 | 0.6 | 74 | 0.8 |

* Numbers may not add due to rounding.

* GDP in 2004 is based on preliminary estimates from Statistics Department

The Government of Georgia has made important structural changes in the Budget for 2005. As a measure to bring greater transparency, extra budgetary funds (pension fund, road fund and medical fund) have been abolished and the expenditure related to these has been incorporated into the Budget, and funded from general revenues. Accordingly, revenues from extra budgetary funds (3.5% of GDP in 2004) have been abolished. Minimum wages have been increased from GEL 20 in 2003 to GEL 115 (about US\$ 65), and salaries of middle and higher officials have been significantly increased. As a result, government's wage bill will increase from 3.4% of GDP in 2004 to 4.1% in 2005 – a relatively low number by regional and international comparison. Likewise pensions have been raised from GEL 18 in 2004 to GEL 28. These will have significant impact on the Budget, but are likely to be absorbed if the fiscal reform is further consolidated, and revenues continue to be buoyant. Part of the adjustment in salary has been achieved through downsizing the bureaucracy and dismissing corrupt officials without making severance payments. This process is expected to continue in 2005.

A new tax code was passed by Parliament in early January, which has eliminated a number of nuisance taxes and reduced the total number of taxes from 21 to 8. In order to encourage voluntary compliance and introduce simplicity, the rate for several taxes have been reduced - VAT has been reduced from 20% to 18%, payroll taxes from 33% to 20%, personal income tax from two rates of 12% and 20% to a flat rate of 12% without any basic exemption. The loss of revenue is expected to be compensated by raising excise tax rates on petroleum products, automobiles, tobacco and alcohol.

The Ministry of Finance has been downsized and a more functional structure has been put in place. Several of the local advisors, trained in the Ministry of Finance and the Budget Committee earlier by the USAID project, now occupy high positions of Deputy Ministers in the Ministry of Finance and the Head of the Treasury Department. While these are excellent resources for a reform oriented MOF, it has resulted in erosion of the capacity to do analysis at the working level.

1.1. Possibility of Revenue Shortfall in 2005

Current Situation

Encouraged by the massive increase in revenue in 2004, the revenue estimates for 2005 have been quite ambitious. For the overall tax revenues, the increase of about 8% in nominal terms (or no increase in real terms) appears reasonable. However, in light of the tax reform measures taken through the Tax Code, estimates of revenues from each tax separately seem to indicate a possible risk of shortfall in revenue targets, especially in profit tax and VAT revenues.

During the year 2004, an impressive drive to curb tax evasion, including large-scale arrests of individuals suspected of tax and refund frauds, and the annexation of Adjara, led to an unusually high reporting of sales by large private companies. As a result, the tax base has been substantially broadened. The revenue trends in 2003 and 2004 show that while excise, domestic VAT and income tax revenues in 2004 have followed the trend of 2003, there are large upsurges of revenues in VAT on imports, customs, and profit tax (profit tax is paid on quarterly basis).

Sustaining this increased tax base, let alone broadening it further, would be a challenge, and would require comprehensive process re-engineering in the tax department to encourage voluntary compliance. Coercive measures are helpful in broadening the tax base in the short run, but enhancing it over a medium term can be done mainly through simplifying procedures to incentivize voluntary compliance and achieve long-term base stability. While the Tax Code has made important changes in the tax structure, little attempt has been made to improve processes. The table below shows the percentage change in tax revenues year-on-year between 2003, 2004 and 2005.

Table 2. Percentage Change in Tax Revenues Year-on-Year (2003 – 2004)

| Revenue Type | Actual 2003 m GEL * | Actual 2004 m GEL | % Change | Estimate 2005 m GEL | % Change |
|-----------------------|------------------------|----------------------|--------------|------------------------|--------------|
| Total Revenues | 1,349 | 2,296 | 70.2 | 2,371 | 3.2 |
| Tax Revenues | 1,250 | 1,932 | 54.6 | 2,084 | 7.9 |
| VAT | 415 | 628 | 51.3 | 816 | 29.9 |
| Income Tax | 153 | 269 | 75.7 | 226 | -15.8 |
| Profit Tax | 102 | 162 | 59.2 | 229 | 41.7 |
| Excise | 106 | 164 | 54.1 | 319 | 94.6 |
| Customs | 70 | 100 | 42.4 | 119 | 18.7 |
| Social Taxes | 223 | 402 | 80.5 | 301 | -25.1 |
| Road Tax | 52 | 74 | 40.9 | 0 | -100.0 |
| Other Taxes | 129 | 134 | 4.1 | 75 | -44.4 |
| Non-Tax | 93 | 274 | 195.0 | 186 | -32.1 |

* Numbers may not add due to rounding.

Examining the revenue dynamics in the light of the changes made by the Tax Code we notice the following:

- Considering that, in the Tax Code, the VAT rate has been reduced from 20% to 18%, and the tax base has no significant addition, a 30% increase in nominal revenues seems ambitious. In view of the fact that there was already a 51% increase in revenue in 2004 as a result of tax mobilization measures by the tax administration, any further increase would seem to be only marginal.
- While the Tax Code has eliminated some exemptions from Profit Tax, it does not seem to warrant a 42% increase, given that a 59% increase was achieved in 2004 as a result of tax mobilization measures.
- The revenue numbers (increase/decrease) for income tax, excise, customs, social tax etc., seem to be generally in line with the changes made in the Tax Code.

Overall tax revenues shown in the Budget 2005 (GEL 2084 m) is considerably higher than the GEL 1946 m indicated in the IMF Staff Report (which itself was based on the assumption that the VAT rate would be reduced from July 2005 instead of January 2005. The Tax Code seems to indicate that the VAT rate reduction applies from January. This would indicate even lower overall revenues.

Recommendations

- **Conduct a review of the revenue dynamics** and to suggest adjustments and remedial measures in the Budget for the Government to correct any potential fiscal imbalance if the trends during the first two quarters indicate that revenue collections are not matching those indicated in the Budget estimates.

1.2. Limited Capacity to do Macroeconomic and Revenue Forecasting and Analysis

Current Situation

For the last several years, the Ministry of Finance has been unable to present reliable and accurate forecasts of revenue. Actual tax collections registered significant shortfalls compared to revenue forecasts in 2001 to 2003. For the year 2004, revenue forecasts were significantly underestimated. The Ministry of Finance has very strong, capable and insightful leaders at the top of its organization, but below this level, the analytical capacity is weak. Several of the young local consultants, trained in the Ministry of Finance and the Budget Committee earlier by the USAID project, now occupy high positions of Deputy Ministers in the Ministry of Finance and the Head of the Treasury Department. While these are excellent resources for a reform-oriented MOF, it has resulted in erosion of the capacity to do analysis at the working level.

The Financial Statistics and Macroeconomic Division in the Financial Policy Department of the Ministry of Finance develops model-based forecasts of macroeconomic indicators based on national income accounts generated by the Department of Statistics. These forecasts feed into the revenue estimates for the budget. An econometric model was developed by the USAID-funded Fiscal Reform Project a few years ago and is now being updated by an EU-funded project through June 2005. Although the staff of about 10 in this Division has been trained in the techniques of macroeconomic forecasting it lacks the experience of putting these techniques to practical use in fiscal/tax analysis. The staff has limited experience in doing micro-simulation analysis or in evaluating different policy options for the policymakers. There is also an Economic Analysis and Policy Department in the Ministry of Economy (MOE) and it too has limited capacity and experience to conduct any meaningful economic policy analysis. Likewise, the Tax Department is unable to do any reliable impact analysis of tax changes such as generate information of revenue collection by types of taxpayers.

Thus, there is a great need to supplement the macroeconomic forecasting assistance provided by the EU by providing USAID technical assistance in augmenting the capacity of the staff for fiscal policy analysis. The nucleus for providing assistance to such an entity already exists as the Government has recently, as part of its civil service reform, pooled resources from the Tax Department, MOE and MOF. Assistance is needed to strengthen the ability of the staff to present detailed information on the implications of current receipts and to analyze the effects of different expenditure and revenue policy alternatives. This function can be integrated in the Ministry of Finance and will strengthen the MOF's ability to present estimates of future collections that are based on solid analysis of current events.

Similar to the situation in the MOF and the MOE, the Budget Committee of Parliament, is also handicapped by a limited analytical capacity. Many of its staff was earlier trained through USAID funded program, but some of its members have moved to other government agencies and the private sector. While these are useful resources for Georgia, this affects the capacity of the Budget Committee. There is thus an urgent need for providing technical assistance to the technical staff in this Committee. The capacity to analyze the Budget is also undermined by the fact that the budget is presented to Parliament in a non-transparent manner and contains limited information. The role of the Parliament has been further diluted by the fact that a Constitutional Amendment requires Parliament to pass the Budget within the stipulated deadline or face dismissal. While this is a democracy and governance issue, it does highlight the need for Parliament to have powerful analytical tools for contributing to informed decision making in public finance.

Recommendations

- ***Strengthen the institutional capabilities of the Ministry of Finance and its subsidiary departments, the Ministry of Economic Development and the Parliamentary Budget Office to formulate and implement sound economic and fiscal policies.*** There is good, young, bright reform-minded leadership in the Ministries, but there is a need to build a more robust capacity with these Ministries.

- ***Develop a true human resource function*** to assist in creating a capable and sustainable staff structure and complement.
- ***The Ministry of Finance staff should be provided training in the economics of taxation, tax policy and revenue analysis tools including micro-simulation analysis.*** An important aspect of the training should be for the staff to be working together with the long-term advisor, who, in the role of a mentor, would handhold them on actual issues for tax policy analysis. As the staff gains experience, the role of the advisor will gradually transition to providing regular oversight and guidance on the work done by them. Training could also include some study tours abroad.
- ***Designing Budget documents*** that are detailed enough for Parliament to make effective contribution to the process and facilitate transparency. This should be further buttressed by designing public education and outreach program for the budget.
- ***Improve the Budget Committee of Parliament's fiscal policy analysis capabilities*** in order to fulfill its role more effectively in examining budget proposals presented by the Government.

1.3. Poor Quality of Database

Current Situation

Poor quality of database is an additional handicap for the Government of Georgia on top of the limited capacity for policy analysis in the various economic agencies (MOE, MOF, Budget Committee and the Tax Department). The problem is not so much the absence of database as the reliability and accuracy of the information. The main source of macroeconomic database is the Department of Statistics, and of the revenue databases are the Tax Department, the Customs Department and the Treasury Department.

The Department of Statistics has an impressive array of publications and does regular periodic surveys. It carried out quarterly income and expenditure survey of 3,351 households (including 1,000 in Tbilisi). Enterprise survey is conducted for annually for 27,000 SMEs, and monthly for 3,000 large enterprises. The Department has been receiving technical assistance since 1996 on price statistics from the IMF, and on national income accounts from the World Bank (through Kennedy Statistics). DFID has provided assistance since 2001 on social trends and EU-Tacis since 1993 on household surveys and special surveys. Recently, the Department has carried out special surveys of gas stations, beauty salons, transport sector and bazaars.

One of the main challenges to the Department of Statistics is that the information supplied by enterprises is largely inaccurate, and compliance is poor. As a result, the Department does not have a good handle on the size of under-reporting, and of the shadow economy.

The Government of Georgia does not have a good handle on inter-enterprise arrears, and bank guarantees issued by the government on state enterprise debts. These are

potential contingent liabilities for the government, which are not properly recorded and may come to haunt the Government at some stage. In order for its data to be more reliable, the Department has requested for technical assistance in carrying out an enterprise census and for doing a more robust study on the size of the shadow economy, using modern methodologies of analysis.

The Treasury Department generates revenue data by category of taxes. Neither the Treasury nor the Tax Department have database on revenue is not collected by type of taxpayers or by other information available in the tax declaration. Without this, tax analysis of any kind can only be done in a rudimentary fashion, and modern tools of analysis cannot be used.

Recommendations

- ***Enhance the overall quality of macroeconomic and revenue analysis*** in the MoF could be enhanced by providing long-term technical assistance to the Department of Statistics to improve the quality of its data. Short-term assistance should also be made available for in conducting an enterprise census and a specialized study on the shadow economy. The assistance in these areas should focus on training in modern techniques in sampling and survey to comb the data for quality.
- ***Develop database from tax returns that could be used for micro-simulation analysis and other impact analysis techniques.*** The assistance should include training for the staff working together with the long-term advisor. Training could also include some study tours abroad.

2. TAX POLICY AND REVENUE ADMINISTRATION

2.1. Tax Policy

As part of the tax reform measures of the Government of Georgia, the new Tax Code was passed by Parliament in early January. This Code has eliminated a large number of small taxes that were more in the nature of nuisance taxes than major revenue raising instruments. From a total number of 21 taxes, Georgia now has Income Tax, Profit Tax, VAT, Excise, Social Tax, Property Tax and Tax on Gambling Business. During the development of the Tax Code, technical assistance was provided by a variety of experts from the IMF, the EU, American Chamber of Commerce, and UNDP (Prof. Robert Conrad).

One of the main themes of the tax reform effort envisioned in the Tax Code was to simplify the tax system and make it easy to administer and enforce. Another important theme was to encourage voluntary compliance by distributing the tax burden more equitably. As in most post-Soviet countries, the high payroll taxes and social contributions in Georgia drive employment into the shadow economy. Employers typically show a smaller number of employees than they have, and show them working at minimum wages when they would actually be working on

competitive market wages. To encourage voluntary compliance, the rate structure has been simplified and the rates of taxes that affect wages have been reduced. Personal income tax has been reduced from a 5-bracket rate schedule, with a top marginal rate of 20 percent, to a flat rate of 12% without an income threshold. Total social tax contributions to several different funds, with the employer paying 31 percent and the employee paying 2 percent, has been modified to a single social tax of 20 percent. This is a significant reduction of 13 percent of the wages. In an effort to encourage voluntary compliance in VAT and reduce undisclosed sales in the shadow economy, the VAT single rate has been reduced from 20 percent to 18 percent. The 20 percent rate is the standard in most transition economies, with the exception of Azerbaijan and Macedonia having an 18 percent rate and Kosovo a 15 percent rate.

While the IMF has supported most of the tax reform measures, and has indeed been an active partner in the reform effort, it had advised against reduction in the rates in VAT and income tax and for a gradual reduction of social taxes to 20 percent over a six year period. The Government and the Parliament, however, decided in favor of reduction in all the three taxes all at once. While the IMF advice is based on prudent fiscal management, the Government's approach is based on the idea of creating a huge impact while the reform is in progress. There is some wisdom in this approach too. In a society where the shadow economy is believed to be 58 percent of the total economy, small changes in rates go unnoticed and do not change the behavior of economic agents. Only a reasonably large reduction in rates can incentivize people to move into the formal economy. There is, of course, the risk of that not happening and then, instead, there being a slippage in revenue performance. In our opinion, the risk is worth taking, and if the reduced rates will help more income and sales being disclosed in the formal economy, the increased base could more than compensate for the lowering of rates, and be more sustainable.

Although VAT, income tax and social tax rates have been reduced, there has been a substantial increase in the rates of excise (the so-called sin/luxury taxes) on alcohol, petroleum products, tobacco and automobiles, in an effort to compensate for the lowering of the rates mentioned earlier. Earlier, excise tax on petroleum and automobiles were low by international standards.

In the area of profit tax, the rate has been maintained at 20 percent, which is at the low end of profit tax rates in transition economies. It is a good rate to have, to provide a comparative advantage for business in Georgia. Most of the changes in profit tax have been made to limit the number of exemptions, streamline depreciation allowance more closely to international best practice, to remove ambiguity in some existing provisions, and to introduce certain restrictions on thin capitalization. There are very small revenue implications of these changes.

In the property tax regime, the Tax Code has made taxable the value of automobiles that are less than five years old and for yachts, planes and helicopters. The property tax rates for real estate owned by individuals has been differentiated for individuals of varying income groups, with no tax for property holders with annual income less than 40,000 laris, and rates in three separate slabs based on annual income. The valuation of land is based on a table of presumptive rates for land in various cities and towns. An administrative provision has been included in the Tax Code that requires parties registering a real estate sale deed to first obtain a tax clearance certificate from the tax department confirming that the tax has been paid.

A new law on tax amnesty has been passed recently, according to which the Tax Department is prohibited from auditing natural and legal persons who had not declared their incomes for the period preceding 1 January 2004. The undisclosed income or property from will be legalized on payment of a token tax of one percent of the undisclosed income/asset. The benefits of the Law do not apply to those natural and legal persons who have declared their incomes for the period proceeding the 1 January 2004. This system discriminates against taxpayers who have honestly been paying their taxes, and is a discouragement to voluntary compliance. Normally when an amnesty is granted, erstwhile tax evaders are allowed the opportunity to disclose their evaded income/wealth, on the assurance that penalty and fines will not be levied and they will not be imprisoned. However, in most systems, they do have to pay the tax due to the government.

2.1.1. Issues with the Tax Code

Current Situation

Overall, the structure of the tax regime based on the new Tax Code is sound. Many good suggestions from the group of advisors working on the Tax Code were incorporated while several others have not been included. The new Tax Code is a good statute to start with, but there are several key areas of concern that need to be addressed by the Tax Code. A review of the Tax Code will be in order later in the year. Several government agencies and private groups have already approached the government for changes.

Personal Income Tax

The personal income tax is a flat tax and has no exemption threshold. Although a flat tax lacks progressivity, it can be justified on ground of simplicity. Less than ten countries, including some transition economies have adopted flat tax. However most of them have rates in the range of 15 to 25 percent.

Typically top marginal rate for income tax, or the flat tax rate, should correspond to the corporate/profit tax rate in order to prevent tax arbitrage by switching income from a legal entity to an individual. In the new Tax Code, the gap between a profit tax rate of 20 percent and a flat tax income tax rate of 12 percent will provide huge opportunity for transferring income from companies to individuals, in the form of subcontracted job work, commission, business fees and interests.

Secondly, the absence of a personal exemption makes the tax difficult to administer. The personal exemption is typically intended to provide progressivity by not taxing income up to a certain subsistence level. Without a personal exemption, everyone with even one lari income theoretically becomes a taxpayer regardless of income level. This will not only hurt the poor workers and small traders but will also grossly increase the number of taxpayers paying insignificant amount in taxes, and will become a burden for the Tax Department.

Thirdly, the Code exempts from income tax 24 categories of self-employed entrepreneurs working within a limited space (square meters of space indicated) separately for each category. Yet, the Code requires them to file a simplified income and expenditure statement every quarter. The logic of requiring quarterly returns from specifically categorized exempt small taxpayers is not clear.

Profit Tax

In the profit tax there is some ambiguity about the taxation in the case of mergers and acquisitions, the base for calculating depreciation allowance, and the taxation of financial lease

Excise tax

In excise on automobiles, specific rates are stipulated, in terms of cubic meters of engine capacity and the age of the vehicle. High excise on motor vehicle can be justified on the ground that car owners in transition economies are in the higher income levels, and also on the ground that it compensates the negative externalities caused by pollution and traffic congestion. However, specific rates ignore the fact that there are large differences in the value of automobiles within the same engine capacity. Specific rates are normally used for administrative reasons for many commodities with uncertain prices, but for cars, there is an active market of new and used cars and the value can be determined fairly easily. An *ad valorem* tax is the best option for excise on automobiles.

Property Tax

The advisory group on the Tax Code had suggested real estate type of property tax to replace the soviet style property that includes the book value of assets of enterprises including fixed assets. The Tax Code has, however, maintained the earlier tax system with the exception that individuals are also taxed in respect of value of land and real estate, as well as on automobiles, planes and helicopters. The Government intends to move to a modern real property tax in the near future.

The Code provides an exemption limit of 40,000 laris. This is very unusual and drastically erodes the tax base for property tax for individuals. In a country with per capita income of about 2,000 lari, households with annual income of 40,000 laris are well inside the top decile of income. The intention of the Government appears to be to spare from the tax individuals with large real estates but with low income (40,000 lari is not low) on the ground that they will not have the means to pay the tax. The main idea of a property tax is to incentivize the real estate market, and providing this exemption will discourage people with large estates from selling their property.

Recommendations

- **Review the Tax Code**, including its provisions, towards the end of the year if the IMF considers a review necessary and if the Government is ready to address the requests made by various stakeholders to review the provisions.

2.1.2 Continuation of Old Procedures not Conducive to Voluntary Compliance

Current Situation

Discussions with representatives of taxpayers showed that the Tax Department still follows antiquated procedures. Taxpayers are not so much bothered by high taxes as with administrative hurdles, long drawn processes and delays in decision. Taxpayers are often unsure about which of the tax inspectors is attending to their petitions. Sometimes, a decision has to be taken up stage by stage by several inspectors, and the matter gets lost in files. Hence the compliance cost of taxation becomes very high and provides the major reason for tax evasion. The Tax Code has not changed these processes, nor is a tax code intended to address this issue. Without simplified, fast track, and user-friendly procedures and processes, voluntary compliance will remain relatively low. For a sustainable tax reform, reform in processes is imperative.

Recommendations

- ***Review and revise administrative provisions of the Tax Code to clarify and minimize the compliance burden on taxpayers.***
- ***Provide technical assistance in process re-engineering in the Tax Department.*** This assistance should include process mapping, examining of the processes that are redundant or counter-productive and developing modern, user-friendly processes. This assistance should be closely coordinated with the technical assistance on IT in the Tax Department, so that the newly developed processes are integrated.

2.1.3 Absence of Fiscal Cadastre and Weak Capacity for Property Valuation

Current Situation

There are 800,000 households owning property in Georgia. With an exemption limit of 40,000 laris annual income, there are expected to be 10-20,000 individual property tax payers. Assuming that this exemption will be removed, or lowered, we could see a much larger number of taxpayers.

The State Department of Land management was earlier charged with land registration and land management. Starting September 2004, a new agency, the National Agency for Property Registration (NAPR) has been established to focus on property registration and land cadastre, while land management has been taken over by other line agencies. The NAPR is hiring 400 employees to help complete registration of all property within Georgia and create a land information system. KfW, UNDP and USAID are providing assistance in land cadastre activity.

Discussions with the Tax Department and the Deputy Minister for Justice indicated that there are virtually no trained human resources for carrying out valuation of

property, which will become necessary with the implementation of property tax. It was mentioned that the staff has no clear idea of zoning and there is no clear guidance on valuation, although the MOF is preparing a draft law on valuation. Over the next 5 years, property will gradually be valued in a phased manner. Accordingly there is need for integrating the land cadastre and property registry into a fiscal cadastre, where the value and other economic attributes of property and rights over it are all integrated. This needs close coordination between the Tax Department and the NAPR.

Recommendations

- ***Develop a fully integrated land information system with a fiscal cadastre*** for an efficient real estate market, leading to land being put to its highest and best use, as well as creating a source of robust urban tax revenue.
- ***Create a modern land information system*** that factors into banking, financial and tax reform, and leverages these databases productively.
- ***Build capacity*** in property valuation, using modern diagnostic tools, and computer-aided mass appraisal (CAMA).

2.2. Tax Administration

The tax administration in Georgia is the responsibility of the Tax Department under the Ministry of Finance. USAID has been working with the Tax Department for several years in an effort to modernize and reform the tax administration, initially from 1997 until 2002 then again commencing in October 2004, in cooperation with implementing partner BearingPoint, Inc. During that period a number of improvements to the tax administration system were introduced. Key reforms of the system included:

- The Tax Department was reorganized in a significant move away from the old Soviet-style system of organizing according to tax type to the modern, more efficient system with reduced opportunities for corrupt practices of organizing according to function. The field offices of the Tax Department were organized according to seven functional divisions - administration, data processing, audit/control, collections, legal, appeals and taxpayer services.
- The restructuring of the Tax Department reduced the number of offices, from 79 to 17 major offices; 14 intermediate offices; and 41 shop-front offices, with 2-3 staff only. These were identified as 'A'; 'B'; and 'C' Type offices, where an A-type office is a fully functioning RTI, encompassing all seven activities listed above. Type B offices were limited to operational functions - taxpayer services, data processing, audit and collections. Type C offices were limited to taxpayer services and collections. Over the past year the Tax Department made further improvements by consolidating this structure into 12 local tax offices, and by reducing staff to the previously recommended organization consisting of about 1750 employees.

- A Tax Information System was developed and introduced that provided for automated Taxpayer Registration, Tax Return Processing, Tax Payment Processing and Tax Accounting. The system also provided for a number of management reports in support of performance measurement. The Tax Department continued to develop the system, particularly in the area of audit where work is underway on an audit selection and case tracking system.
- The Large Taxpayer Inspectorate was centralized and the Excise Tax Inspectorate was established that centralized the administration of all excise taxpayers and excise stamps.
- The utilization of Excise Tax Stamps was introduced as an integral component of the excise compliance and control system.
- Sustainable training capacity was developed with the implementation of a dedicated and equipped training department. The Tax Department has continued with this effort and now requires all training be conducted or coordinated through this centralized unit.
- Additional capacity for the fiscal system in Georgia as a whole was achieved through the development of human resources who were employed on the USAID Fiscal Reform Project (1997-2002) and who now occupy senior posts, such as Deputy Ministers of Finance, within the GoG.

With the November 2003, so-called “Rose Revolution” and the accession of Mikhail Saakashvili to the Presidency in the January 2004 elections, USAID determined that additional assistance to the Ministry of Finance (MOF) was warranted and BearingPoint was asked to conduct a one-year task to provide advisory, training and commodity support directly to the national-level policy formulators and policy makers in the GoG’s Ministry of Finance. This assistance commenced in late October 2004.

Current Situation

The Tax Department, with the immediate assistance of the new USAID Fiscal Reform Project, is currently in the process of introducing reforms aimed at improving taxpayer compliance through simplification of the tax system and a concerted effort to reduce the administrative burden on taxpayers. At the same time, reforms are under way that address the issue of non-compliance and the extensive shadow economy. It is apparent that the Tax Department has embraced the concept that the successful administration of the tax system in Georgia is contingent on the implementation of processes that support the development of voluntary compliance and self-assessment on the part of the taxpayer. The reforms that have been initiated by the Tax Department, with the support of the Ministry of Finance and USAID/BearingPoint Fiscal Reform Project, include:

- The strengthening of the Taxpayer Service function within local tax offices to conduct public outreach and training programs for taxpayers;
- Strengthening the capacity of the newly formed Excise Tax Inspectorate to receive and process excise taxpayer information in a more timely fashion by developing an on-line, web-based link for taxpayers to submit documentation;

- The introduction of risk management principles to the process of selecting taxpayers for audit or other compliance activity; and
- Strengthening the capability of the Tax Department to detect, investigate and refer for prosecution cases of tax evasion.

The development of commentary to the new Tax Code will form the basis for the production of explanatory material as part of the taxpayer education program.

Information Technology

The Tax Department has a good core system for processing taxes, but this system does not have all the functionality required for modern tax administration. Most of the current tax system was developed through the joint efforts of BearingPoint and the Tax Department. This is a centralized system that has been implemented using Oracle Developer for the application and Oracle8 for the database. Twelve regional offices connect to the tax system via a WAN, which is supported by a service provider. The functions covered by the system include taxpayer registration, returns processing, payment processing, taxpayer accounting, and results of audit. Additional functionality must be added to the system to support collections, audit, and VAT refund processing.

Recommendations

- ***Development of Revenue Analysis Units*** that produce risk assessments for compliance needs of audit, collections, and refund (particularly with regard to exporters).
- ***Re-engineer business processes to reduce administrative burden and utilize systems to electronically submit required documentation.***
- ***Strengthen taxpayer education program*** – by providing training, brochures, internet access. Introduce administrative consolidation of tax and customs functions.
- ***Strengthen functional organization*** through technical assistance to institutionalize the key functions of audit, collections, taxpayer service, appeals and legal, through training, performance measurement, and improved management controls.
- ***Develop human resource strategic plan*** to address employee retention and capacity building through training, job descriptions development, performance measurement and compensation.
- ***Add a case-tracking module as soon as possible in order to track arrears and manage the collections process.*** The Deputy Chairman of the Tax Department, Zaza Kobulashvili, emphasized the need to improve control over the Collections function. Developing and implementing a collections case-tracking module in the system will immediately impact revenue collection.
- ***Add a case-tracking module to better manage the audit function.*** Simply entering the results of audits is not enough. The case-tracking module for

audit should include audit selection and planning, data entry for audit documents, a case tracking interface, and management reporting. Like a collections module, an audit case-tracking module will provide immediate benefits to the Tax Department.

- **Identify risk criteria, provide advice on VAT administration, and develop a robust refund processing system with critical system controls.** Proper risk assessment and administration of VAT must be one of the highest priorities for the donor community.
- **Better sharing of data with other government departments (for example, customs), development of a management information (reporting) system, and upgrading the Tax Department's human resources system.** In general terms, better sharing of data and development of an MIS will improve administration, reduce risk, and provide management with critical information. Enhancing the human resources system, on the other hand, is important for capacity building. These additional enhancements will also require technical assistance to ensure proper implementation.
- **Provide IT technical assistance for advisory services, hardware, software, and training.** Due to the substantial system development and implementation that is needed, advisory services will be required for an extended period. Additionally, IT advisors should assist with system assessments, system security reviews, and data quality reviews. In regard to hardware and software, the Head of IT has estimated that \$2.5 million of funding is required to support the tax processing system fully over the next three years, which is a reasonable figure. (See Appendix 4.) This amount covers automating offices that were not currently automated, purchasing licensed software, and data communications services, and capital expenditures for hardware and software replacements/upgrades. Training is also an important component of technical assistance and should include software training, project management training, and study tours. The IT Department has made significant improvements over the past seven years, and further technical assistance will reinforce that progress.

2.3. Customs Administration

Current Situation

Legal

Customs administration in Georgia is the responsibility of the Customs Department under the Ministry of Finance. The legislative base for the customs system is the Customs Code, the Customs Tariff, and the Law on Customs Fees, all of which were implemented in 1998. This legislative base is recognized both by the GoG and the international donor community to be inadequate for the needs of a modern customs system that facilitates trade while ensuring adequate revenues. The law is unclear, inconsistent with international best practices for customs, and subject to different interpretations, which of course leaves processes open to discretionary practices that provide opportunities for corruption. Since October 2004 the European Union has

been working to develop a new Customs Code that is consistent with the European customs law model that incorporates the trade facilitation recommended practices of the revised Kyoto Convention and World Trade Organization (WTO) requirements such as the Agreement on Customs Value (GATT Article 7). At the present time it seems that the GoG has separate plans to develop their own Customs Code and it remains unclear as to whether the European model will be used in this re-codification effort or not.

Customs Value

The international standard for valuing imported goods is the WTO customs valuation agreement 'On Implementation Of Article VII Of The General Agreement On Tariffs And Trade 1994' which sets out the rules for what is commonly referred to as 'customs value'. Georgia is a signatory to this agreement and has included customs value in the Customs Tariff law, and has produced regulations in this regard. The correct implementation of the law has not taken place and there is no real capacity to administer customs value at the central office or at border posts.

Tariff Classification

The Customs Tariff that is currently in place is not based on the Harmonized Tariff System (HTS). Implementation of the HTS would contribute to the harmonization of Georgian customs and trade procedures with most other trading partners, and the non-documentary trade data interchange in connection with such procedures, thus reducing the costs related to international trade. It is also extensively used by governments, international organizations and the private sector for many other purposes such as internal taxes, trade policies, monitoring of controlled goods, rules of origin, freight tariffs, transport statistics, price monitoring, quota controls, compilation of national accounts, and economic research and analysis.

Customs Procedures

Customs clearance procedures in Georgia have been reformed to a small degree, primarily with regard to the movement of non-excise goods in transit through the country which is no longer subject to obligatory escort under convoy, and with the implementation of the ASYCUDA ++ IT system. The ASYCUDA ++ system provides for the automation of the customs clearance process, however the physical process of moving goods through customs remains a complicated, time consuming, non-transparent exercise that is based on 100% examination of goods and that requires a significant opportunity for interaction between customs officials and importers, which in turn facilitates corrupt practices.

A system of bonds or some other form of guarantee is not in place in Georgia. It is a standard practice for modern customs administrations to provide for the utilization of bonds as a means to protect revenue, and facilitate the movement of goods without the need to pay cash at the time of each importation. Most countries use customs brokers or agents that are bonded and who are paid a fee to utilize their bonds on behalf of importers thereby negating the need to carry large sums of cash. Apart from simplifying the clearance of imported goods at the time of importation, bond systems further provide the opportunity for implementing 'suspension regimes' such as

bonded warehousing, movements of goods in-bond, temporary importation, inward processing, etc. These are significant trade facilitation measures that are an international standard among modern customs administrations. Furthermore, Georgia does not make use of bonded customs brokers or agents and instead use 'declarants' that are paid fees to simply prepare paperwork on behalf of the importer.

Organization and Human Resources

An ambitious plan for reform, including Human Resource initiatives and the organization of the Customs Department has been set out in the 'Action Plan for Implementation of the Development Strategy of the Customs Department'. Essentially the strategy provides a draft plan for the restructuring of the Customs Department, and a draft plan for the development of human resources including testing, training, remuneration, hiring, promotion, and firing of customs personnel. The strategy is fairly comprehensive and addresses many of the reform and modernization issues that must be considered. The Customs Department and the Ministry of Finance will require technical assistance to implement the reforms set out in the strategy document in addition to the reforms that will be required for the modernization of these institutions that are necessary but not covered by the strategy.

The goals for this process are as follows:

- Principle-based customs law that incorporates provisions that give the legal basis for the trade facilitation 'recommended practices' of the revised Kyoto Convention;
- Customs operations that are simplified, transparent and that include the recommended practices of the revised Kyoto Convention such as 'risk assessment' and 'post entry verification';
- Full automation of customs processes with Direct Trader Input capabilities on the operational side and management of information at the Ministerial level;
- Implementation of the Harmonized Tariff System;
- Customs organization that supports the modernization process and that is dedicated to the development of and appropriate compensation for human resources; and
- Modern, transparent customs system with a Code of Ethics founded on the principles of the revised Arusha Declaration, and that has modern internal controls in place.

Information Technology

The Customs Administration uses ASYCUDA++ version 1.17D, an old version based on DOS-technology, for customs clearance. ASYCUDA has been implemented as a centralized system at headquarters and runs on an Informix database. PCs in customs houses and border points connect to the system via a WAN, which is supported by a service provider. While ASYCUDA is fully functional, additional hardware is needed to ensure its reliability.

Customs has expressed an interest in upgrading to ASYCUDA World, a JAVA-based system. While there are advantages to ASYCUDA World, it is not clear that Customs needs to upgrade to the latest version at this time, since ASYCUDA++ satisfies the Customs Administration's current functional needs. The strongest argument for ASYCUDA World is that it is Internet enabled. This will facilitate trade because it will be easier for traders to submit manifests electronically, and customs employees will be able to connect to ASYCUDA World from any computer connected to the Internet. One important point is that there would be significant cost savings to the Customs Department with ASYCUDA World because data communications services would no longer be needed. (ASYCUDA++ relies on dedicated connections provided by a service provider.) As a counter argument, ASYCUDA World apparently has not been implemented in any other countries yet (see asycuda.org), and Georgia may not be a good testing ground for a new customs system. Another option is to consider commercial customs systems that are on the market. For now, upgrading to a more robust customs system is not a high priority.

Recommendations

Legal

The re-codification of the Customs Code must be the priority, as it will provide the legal basis for the reforms that are to be undertaken. The new Code will have to address the following principles:

- Clarity and simplicity in drafting with a view to minimizing opportunities for evasion and avoidance.
- Inclusion of modern customs regimes particularly those related to control of goods and trade facilitation.
- Effective powers for customs officers, particularly in connection with enforcement and recovery action.
- Effective provisions for sanctions.
- Effective taxpayer rights and/or an effective appeals procedure.
- Conformity with the principles of the Kyoto Convention (revised) on the simplification and harmonization of customs procedures.
- Conformity with World Trade Organization (WTO) requirements such as the Agreement on Customs Value (ACV).

The new Customs Code should not contain a great deal of detailed, procedural information. This has a tendency to over complicate the law that in turn can lead to abuse by authorities when dealing directly with ill informed importers/exporters. It also leads to instability since any changes to procedural matters (a common occurrence) lead to a need to change the law itself. It will be more efficient to ensure that the law is principle based and that procedural matters be left to the Regulation process. The process of putting detailed procedural matters in Regulations that are subordinate to the primary legislation is a good one and is well understood worldwide. The advantage of Regulations is that they can be more readily amended to deal with new or changed circumstances and sometimes to correct errors without

having to go through the parliamentary process. They can also be written in language that is more easily understood by the importing/exporting community.

The language or terminology utilized should be harmonized with international standards, generally as provided for through the World Customs Organization (WCO) or the World Trade Organization (WTO) and particularly with regard to IT development. This would cover such concepts as customs value, risk assessment, origin, tariff classification, etc. Furthermore, organizing the law according to key concepts such as, for example, placing all provisions dealing with 'appeals' in one section, will help to simplify and clarify the legislation.

The new Customs Code must provide the basis for an effective customs regime. It must include provisions that the WCO has laid out for a modern customs organization. For the most part, these can be found in the Kyoto Convention (revised). The Convention sets out a number of recommended practices for customs administrations to adopt that essentially significantly improve trade facilitation. For example, the current practice of 100% examination at the border should be replaced with a system of targeted examinations based on risk assessment, and verification should be assured through the use of periodic 'customs audits'.

The new Customs Code must be compatible with the following:

- Harmonized System for Tariff Classification;
- Excise Law;
- Value Added Tax;
- Amendments to accommodate the recommendations under the revised Arusha Declaration;
- Single Taxpayer Identification Number;
- Reforms to Customs Broker system;
- Reforms for Personal Allowances; and
- Information sharing within the Ministry of Finance.

Customs Valuation and Tariff Classification

Tariff classification under the Harmonized Tariff System and the customs value system cannot easily be administered at the time of clearance and can be most effectively administered in a post entry environment, supported by customs officials at the point of entry. In order to be properly verified tariff classification and customs value requires access to books and records by competent personnel.

There are several advantages to adopting this approach, in particular with regard to customs valuation:

- Customs value is also the definition that is used to describe the "taxable value of an imported supply" under the VAT legislation. Improper calculation of the customs value at the time of importation will likely result in a "cascade" effect that can ultimately result in revenue leakage throughout the system.

- Customs value supports the principles of a market economy. Proper calculation of customs values takes into account normal business practices that in turn promote voluntary compliance. The system is transparent, business understands it, it is fair and it is neutral (the imposition of customs value does not cause businesses to have to change normal procedures in order to comply). This will encourage overall compliance that in turn will increase the "tax base" thereby increasing revenues. At the same time, legitimate trade is facilitated.
- Customs value is the international standard. Proper calculation of customs value will ensure that importers are being treated in the same way as their competitors. In this global economy it is absolutely critical that businesses are able to compete internationally and that no undue impediments stand in their way. Domestic businesses that are allowed to thrive will see increases in profits that in turn are the source for additional revenues under income tax laws.
- Customs value broadens the base from which duties and taxes are collected at one of the earliest stages in economic activity. There are a number of additions to the definition of "price paid or payable", such as royalties, commissions and license fees and assists those that are also subject to the payment of duties and taxes. Since customs value is being applied at the time of importation, government budgets will see the additional revenues at the earliest possible moment.

Customs specialists in valuation must be developed at the central office where field personnel and the public can draw upon their expertise.

As well, a system of binding customs rulings should be developed that can be obtained in advance by the business community. This is also an important function for centralized customs specialists that help to stabilize revenue collections while facilitating trade at the same time. This function is not in place at this time.

Customs Procedures

Trade facilitation requires a more simple and transparent, automated customs system that results in quicker clearance of goods. While any customs system that lacks simplification, lacks transparency, and that doesn't reduce the amount of interaction between the business community and the customs officials can give rise to opportunities for corruption, it is the delays and complication inherent in the customs system that generally cause the greatest concern for the business community.

The customs clearance process should be restructured and automated to the greatest extent possible. If implemented correctly, this will introduce simplicity and transparency to the system, and will in turn increase the effectiveness of the Customs Department. The process must ensure that customs declarations are processed, risk analysis conducted, and then decisions taken as to the nature and degree of intervention that customs will make when the goods arrive or when goods are exported. The automated system must also ensure that all interventions are monitored thus introducing opportunities for effective internal controls and accountability. In addition to making the system more simple and transparent, the IT

system must provide the means to gather, analyze and disseminate accurate trade data in a timely fashion.

A key component of an effective customs system that protects revenue while facilitating trade is a reliable bond/guarantee management system. A properly functioning system allows officials to suspend the payment of duty and taxes pending the completion of an authorized activity. In order for the system to function correctly, the bond must be sufficient to guarantee the payment of the appropriate revenue should the need arise, and must be fully actionable by the beneficiary (the government) at all times. The system must also provide timely, accurate information to the customs authorities of the compliance level of the bondholder so that decisions can be taken proactively. Trade facilitation can also be improved in administrations that wish to provide an incentive to bondholders that operate in a compliant fashion by aligning the value of the bond with the compliance level of the bondholder.

A system of bonded customs brokers who meet an established level of competency, and who are licensed, monitored and controlled by the Customs Department, must also be implemented. This will ultimately increase the quality of the customs declarations especially with regard to tariff classification, origin and valuation. Brokers are also key to trade facilitation as they help to ensure that goods flow freely and in a timely fashion through the customs process.

The principles of selectivity and targeting in the form of risk assessment are not part of the Georgian customs system. The Customs Department must develop the means to address the critical components of an effective system of selectivity and targeting. These include a database of importers, exporters, logistics providers, and commodities. The capability to exchange information with the Tax Department in a timely and effective manner is also required. This is especially critical for the verification of exports that are zero rated for the VAT. The determination of compliance ratings that can then be employed by customs as criteria for targeting and selectivity is essential to the process, but is also not a capability that is in place.

'Post entry verification' or customs audit functions are not part of the current customs administration. This function is critical as a means to effectively follow-up on those importers granted expedited clearance at the time of entry, and is an integral component of a customs system that facilitates trade. It is also an effective means to refine information that is used to maintain effective and timely criteria for selectivity and targeting purposes.

The further development of automated systems in Georgia should include a module for exports. The export system should provide for selectivity and targeting of exported goods, taking into account information provided by the VAT officials in the Tax Department as to the compliance level of the exporter. In this manner, intervention by customs officials will be reduced, exports will be verified for VAT refunds, information will be provided to the VAT officials in a timely fashion, and accurate statistics will be compiled. The system will be more effective and transparent, opportunities for corruption will be reduced, and there will be further integration or harmonization of the activities of the customs and the VAT organizations.

Organization and Human Resources

The Human Resource function in the Customs Department must be strengthened and further developed in accordance with the 'Development Strategy of the Customs Department'.

Recruitment and probation procedures must be developed and be by open competition, promotion should be based on regular performance appraisal and lateral transfer procedures should be nationally advertised.

The development of a job classification and evaluation for all posts within the Customs Department is a requirement. This should include establishing the complement and grade of staff required in each department needed to efficiently and cost effectively fulfill their legal and civil responsibilities. It should also provide a clear job description for each category of individual post holder. This work will create significant further work for the HR Department. It is difficult and requires specific expertise to evaluate exactly the extent of resources that are required. Nevertheless it is a key factor in operating an effective customs administration.

The dedicated Training Unit in the central office of the Tax Department supports the training needs of the Customs Department. A Departmental Training plan should be developed that includes regular formal classroom training as well as on-the-job training. The Departmental Training Plan should incorporate a requirement to produce short, medium and long-term training plans. Courses should be designed to give all staff the knowledge, skills and confidence to enable them to perform their duties effectively. All courses should have an element of classroom work and practical work in a live situation. The classroom work should include role-play and discussing real situations. Each student should maintain a training log, which must be produced to and reviewed by the Training Unit working with the HR Department.

The development of a computerized Human Resource Information System that will readily provide necessary data and statistical information for management purposes should be given priority.

A system for performance appraisal must be developed that includes the identification of the management roles within the system, the establishment of job objectives, the development of training programs that support the development for managers and staff, and the formulation of sound performance measures. Once this has been completed, a review should be conducted to identify whether pay differentials properly reflect the different responsibilities throughout the organization.

Specific, key recommendations for the reform and modernization of the customs administration in Georgia are as follows:

- **Redraft the Customs Code** to comply with the provisions of the Kyoto Convention (revised).
- **Discontinue the practice of using minimum values** in favor of implementing the WTO Agreement of Customs Valuation (ACV).
- **Implement the Harmonized System for tariff classification.**
- **Carry out an evaluation of personal allowances**, particularly the monetary limit, with a view to restricting commercial imports by regular travelers.

- **Identify specific amendments to accommodate the introduction of the Harmonized System for Tariff Classification**, code of conduct recommendations as per the Arusha Declaration, the utilization of a Single Taxpayer Identification Number, the role for Customs Brokers, and proposed reforms to Personal Allowances.
- **Implement a Single Administrative Document (SAD)** that is computer compatible and that can be used for all customs regimes including export.
- **Implement a customs bond/guarantee program** that includes an effective management system to ensure revenue protection for all suspension regimes and for periodic accounting. The customs bond/guarantee system must enable the Customs Department to easily take action on the revenue security should the goods go unaccounted for;
- **Implement a licensed customs broker program** by:
 - Establishing a specialized unit at the headquarters for the Customs Department that will be responsible for regulating, training and licensing customs brokers; and
 - Providing for and defining the activities that customs brokers can be authorized to conduct under customs bond.
- **Move from exclusive movement controls to more audit-based controls** such as post entry verification of goods declarations, or end-use audit of goods claimed under exemption.
- **Implement a system of targeting and selectivity of transactions and consignments**, both for import and export. To do this the Customs Department will need:
 - Analytical tools to process information submitted to customs according to established criteria. The criteria should be set by a working committee consisting of representatives from customs investigations in the Financial Police and border operations, and should also include representatives from other government departments. The outcome of this will be a better allocation of resources and a reduction in the discretionary powers of the customs inspectors as part of an effective anti-corruption strategy.
 - A Compliance Verification Unit in the central office as part of the post entry verification function to establish a compliance measurement for procedural issues, revenue issues, transport issues and specific concerns including HS tariff classification, origin verification and marking requirements, high revenue commodities, and selected traders.
- **Introduce a more flexible approach to preventive and cargo inspection** by using a “team” rather than static staff system and using selectivity based on risk assessment rather than a one hundred percent inspection technique.
- **Strengthen implementation of the WTO Agreement on Customs Valuation (ACV)**. This will require implementation of a specialized valuation division in the headquarters of the Customs Department that includes personnel who are trained in the principles of customs valuation.

- **Implement specialized units of adequately trained individuals** at the central office of the Customs Department for tariff classification, origin, and a joint customs/VAT audit function.

Information Technology

- **Procure new hardware for the Customs Department.** Since ASYCUDA is a time-sensitive, mission critical system, all reasonable steps need to be taken to avoid hardware failure. To ensure uninterrupted use, the Customs Department needs new equipment for their central computing center to ensure that ASYCUDA is a fault tolerant as is reasonably possible, including:
 - 2 new mid-range servers (one operational server and the other as backup),
 - 1 RAID (random array of independent disks) storage system,
 - 2 heavy duty smart UPSs,
 - 1 backup generator, and
 - 1 midsize air conditioner.
- **Upgrade the Customs Department to at least Oracle9i as the database platform,** due to the uncertain future of Informix (now an IBM product). Beyond equipment for the central computing center, the Customs Department also needs approximately 200 new PCs with peripherals and LAN connections. The new PCs will replace some old ones and also be used for improved customs administration. The hardware and software procurement suggested above is a small investment that would ensure the stability of ASYCUDA and improve the overall operations of the Customs Department.

3. PUBLIC EXPENDITURE MANAGEMENT

3.1. Budget Preparation

Current Situation

Legal Framework

The Republic of Georgia has a very good legal framework for budget preparation, with a Constitution and Organic Budget Law that outline a medium-term expenditure framework. The Law defines an annual MTEF calendar that provides for participation of all the appropriate organizations including Parliamentary oversight of the macroeconomic forecast and medium-term fiscal forecast early in the annual calendar. One weakness in the legal framework is its treatment of the development of investment projects. The law makes virtually no mention of special requirements associated with investment budgeting—there is only a brief reference to investment

projects as one of the items to be included in the Government of Georgia's submission—and thus the Government incorporates the investment budget into the overall budget process.

The Organic Budget Law defines the annual budget calendar with precise dates for each of the key steps in the process. It requires the Government to present the draft budget to Parliament on October 1, with final adoption of the budget law targeted for December 31, giving Parliament a three-month period for its review and final action. The Constitution puts great significance on the *timely* adoption of the Government's proposed budget, with provisions under Article 93 for the dissolution of Parliament if it does not adopt the budget by December 31.

Budget Document

At this point, the Government has not yet developed a means of producing budget documents in a timely and user-friendly fashion. The basic legal requirements for budget document production have come into effect within the last year, and as such the Government is still striving to incorporate them into its procedures and annual calendar.

Article 21 of the BSL requires the Government to publish the draft budget law and associated materials at the time of submission of the budget to Parliament. During 2004, the Government presented the draft law and additional materials in loose-leaf format to Parliament at the time of submission. It did not present a published document, as would be the case in a fully developed budget structure. Conveying the budget in this fashion did not provide an opportunity for citizens, media or other interested parties to gain visibility easily into the budget or the process, and thus the process was less than fully transparent. While the definition of what is to be published, the "draft budget law and associated materials," could be debated in terms of the required materials, what is clear is that the information that was presented to Parliament was not in a conventionally "published" form.

In terms of the content of the presentation to Parliament, the Budget/Finance Committee Chairman depicted it as less than transparent, with little if any program detail, a lack of information on changes to various elements of the budget, very little performance information, and no access to the line-item details that are one level of detail below the major economic classifications. Moreover, it was difficult for Parliament to gain access to the information through follow-up questions to the Ministry of Finance. Consequently, the budget as presented did not allow for adequate Parliamentary review and analysis, nor did it allow for ready access and examination on the part of citizens and other interested parties.

Article 22 of the BSL requires that the budget law and its appendices be published and made available to the public. For the 2005 budget, that has not happened at the date of this assessment, although the Ministry of Finance reported that they are planning to do so during the month of February. It will be important for the Ministry to ensure that processes are in place for the public to gain access to this document.

An important feature of government fiscal transparency is the presence of a Budget Summary document, often referred to as a "Budget in Brief," a "Budget Overview," or

a “Budget Bulletin.” This is a small document that summarizes the key features of the budget, and is intended to be an inexpensive, portable, user-friendly document that has appeal to the media, interest groups, and citizens. It is a low-cost way for the government to reach the widest possible audience with information on their government and its finances. The Government of Georgia does not produce such a document and does not have plans to do this at any point in the future. Through the USAID Fiscal Reform intervention 5 years ago, BearingPoint worked with the newly formed Parliament Budget Department to develop a Budget in Brief. It was published in connection with the 2001 budget but has not been published since. That model could be used as a starting point for the Government to resume the production of this important tool of fiscal transparency.

Information/Data support

The Ministry of Finance’s Budget Department does not have a budget planning and development system to aid in the budget process. The Department uses *Excel* spreadsheets to track and print data. They do not provide the Ministries with templates to use in conveying the budget requests. So in practice, the Ministries key their requests into their own spreadsheets, and then they have to be keyed again into the Budget Department’s spreadsheets after receipt. Similarly, the Budget Department and the Treasury Department do not have the ability to up-load and download the budget information. It has to be keyed each time it is conveyed.

The Department recognizes that it needs a robust automated system to aid in budget development, but it has not yet sought to procure and implement a system. They are favorably inclined to examine commercial off-the-shelf (COTS) packages, but are concerned about the internal capacity to manage and maintain the packages.

Organizational Framework

The Ministry of Finance has defined a Vision Statement that provides a clear, goal-oriented vision to guide the Ministry and the Government as a whole in the Budget Planning process: *“Establishment of financial order, creation of a foundation for stable economic growth, and the reduction of poverty.”* The process, therefore, should be guided by the need to create a fiscally healthy government, provide the means to promote economic growth, and allocate government resources in ways that will reduce poverty.

During the last year, the Budget Department has undergone a significant restructuring, reducing the workforce from 15 to 45. This was achieved by eliminating 120 positions and then adding 25 new employees. The staff is organized around four functional divisions: Territorial Budgets, State Budget, Budget Policy, and Internal Debt. The analysts in the State Budget division are organized within sectoral assignments. At this point, the Department feels that it has a better-educated and competent workforce that is capable of higher-level analytical challenges. The creation of a strong corps of fiscal and policy analysts in this area can serve as one of the key tools in the government’s fiscal reform efforts. Current plans call for the DFID/Dutch Technical team and the US Treasury Advisor to provide this assistance.

Another significant tool to aid in this effort is the current organizational “culture,” which seems to facilitate dramatic changes in staffing and personnel movements with few bureaucratic hurdles to clear. As well, the cost of making large workforce reductions has been minimized through the passage of legislation that waives severance payments for employees who are discharged during the current two-year period. The combination of this type of workforce flexibility, combined with a strong program of technical assistance in budget planning and MTEF implementation should provide an opportunity for rapid and decisive fiscal reform.

Budget Preparation Process

The budget process is defined by Chapter Six of The Constitution of Georgia and the *Law on Budgetary System of Georgia* (the Budget Systems Law, or BSL), both of which contain amendments and new provisions that define the MTEF process. With these amendments, the BSL requires the State Budget to be developed through a medium-term budgeting process and calendar. The stages of the process are well conceived and sequenced in a way that allows time for strategic policy deliberations in the initial stages, and involves Parliament at key steps in the early stages of the process. It defines strong linkages between the resource envelope and the development of sectoral allocations, and ultimately the development of budget requests by the spending institutions. It provides for a three-month review period by Parliament—from the Government’s Budget submittal deadline of October 1 until adoption of the Budget Law on December 31.

The Government has put together a conceptual framework and timetable for the introduction of the MTEF framework during the fiscal 2006 budget process. In the first year of implementation, the effort will focus on the Ministry of Finance and three pilot ministries—Education, Agriculture, and Health and Social Protection. The other ministries are being encouraged to start participation in the first year, but at a reduced level of sophistication. The process is being supported by various components of international assistance, with oversight at the Ministry of Finance being provided through a DFID/Dutch Technical Team, supplemented by a US Treasury Advisor who will join the effort in March 2005. The configuration of international assistance for the three pilot ministries is still being finalized, but is likely to consist of the following:

- Ministry of Education—World Bank support through an existing engagement that is providing general management support, with the possibility of an added Terms of Reference to address the unique requirements of the MTEF process;
- Ministry of Agriculture—EU support over an 18-month period specifically for this purpose; and
- Ministry of Health and Social Protection—support through an existing USAID contract for management support.

At this stage of the process, international assistance has not been identified for any other ministries that may choose to join the pilot process in the initial year. At least one ministry—Environment—is contemplating active involvement in the first year.

The Government has created a MTEF Task Force to guide the effort. It is chaired by the Minister of Finance, with the Deputy Minister of Finance/Budget serving as alternate chair. Other members are the Minister of Economic Development, the State Minister for European Integration, and the Deputy Ministers from the pilot ministries. The process commenced in December 2004, followed by the initial workshops in the Ministry of Finance and the pilot ministries in January 2005.

The Organic Budget Law does not contain any special provisions relating to the Investment Budget, and thus the ministries and the MoF incorporate the budgeting for investment projects into the overall process. The structure of the process and the roles played by each of the ministries in making decisions on investment projects seems to be in an evolving state, in connection with the recent organizational changes in the Ministry of Economic Development. The MED is responsible for developing the Poverty Reduction Plan, which in turn sets the groundwork and policy direction that is to guide the investment projects. And in this regard, the ministries submit their investment budget proposals to both the MED and the MoF. There is not a strong, systematic method of analytical collaboration between the MED and the MoF in the support of decision-making, and the MoF takes a stronger role in the overall analytical process.

The ministries do not have processes or capabilities in place to conduct rigorous project appraisals in the development of the investment projects, nor do the MoF or MED have such processes or capabilities. The projects do not contain impact appraisals that measure the economic, social and financial impact on a long-term basis. Consequently, the MoF does not have a process in place to assess the medium-term and long-term impacts of proposed projects on the government's budget, nor is there a way to integrate the staging of investment projects into a longer-term expenditure plan. The MTEF initiative will provide the framework for the overlay of public investment project impacts on a medium-term fiscal forecast. Successful implementation of this overlay, however, will require extensive enhancements in project appraisal capabilities among the key spending ministries, the MoF and the MED.

Recommendations

While the Government has undertaken an ambitious MTEF implementation process and has secured the assistance of various international donors, there are still some elements of the Budget Preparation process that should be improved during the next 2-3 years in conjunction with the MTEF initiative:

- **Improve the Investment Budget Process** to include improvements in the capacity of ministries to conduct project appraisals and analyze proposed investment projects; enhancements in the Government's priority-setting process within sectors and across the Government-wide spectrum; and improvements in the investment budget process, its integration with the medium-term fiscal plan, and the way it is portrayed in budget documents.
- **Enhance the Government's budget documents** as well as its public education and outreach efforts relative to the budget—to include embellishments to the content of the document, the development of a Budget in Brief, and the creation of other documents and processes to enhance the

public's access to budget information and its opportunities for participation in the budget process.

- ***Strengthen the capabilities of the Parliament Budget/Finance Committee*** to provide stronger analytical capabilities in connection with the Parliament's review of the proposed budget and its involvement in the MTEF process; and to and provide a means for a more meaningful analytical capability to serve as a counterbalance to the strong executive role in the process.
- ***Develop an integrated Budget Information System*** to be staged in connection with the implementation of an FMIS system.
- ***Develop program budgeting capabilities*** to focus on the Ministry of Finance as well as line Ministries as a key supplement to the MTEF initiative.
- ***Strengthen non-pilot Ministries' capabilities in the MTEF process*** to be staged in connection with the rollout of the process to other ministries in the second year of the program and beyond.

3.2. Budget Execution / FMIS

Current Situation

The Constitution and laws of Georgia provide a sound legal framework in which the Government can manage, execute and control its fiscal resources. The Organic Budget Law provides for the basic elements of effective budget execution and control:

- Frequent reporting of financial transactions and performance against budget;
- Quarterly budget allotments;
- The requirement for a Single Treasury Account;
- Restrictions and thresholds on transfers between appropriations within a spending institution and from one spending institution to another;
- The requirement for a mid-year assessment of budget performance and Parliamentary oversight of the assessment; and
- Mandated action to correct budget deficits that are identified in the mid-year reviews.

The government, however, has not yet undertaken the structural reforms that will allow it to realize the full benefit of this legal framework. The most glaring deficiency is the lack of a robust, integrated financial management information system (FMIS). Such a system would provide the information infrastructure that would allow all spending institutions of government to manage their finances efficiently and at international standards of proficiency. At the same time, the system would provide the central support institutions with updated, accurate, integrated information that could be used to help set fiscal policy, make resource allocation decisions, and track and audit the results of government financial activities. It would allow for all the ministries to undertake a process of business process reengineering (BPR), where

they could migrate from largely manual and inefficient processes to a more streamlined and efficient set of processes and procedures. (This can allow for a reallocation of staff resources from central administrative uses to more productive direct services to the public.) And finally, it would provide Parliament and the Chamber of Control with information that is needed for effective oversight and timely reporting.

In the absence of such a system, the government is operating its finances with an array of independent spreadsheets, databases, forms and manual processes. This creates gross inefficiencies for the ministries, which have to commit staff resources to conduct basic, fundamental financial transactions (e.g., purchases, payments, reports, payroll, budget tracking) that could be handled much more efficiently if they had on-line access to an integrated FMIS.

The Ministry of Finance's IT Department appears to have very ambitious plans to integrate the main operational systems of all parts of the Ministry. While the intention is good, integrating these systems at a detailed data level would be very complicated, monopolize resources, take years to complete, and would not produce the desired results. The Ministry should instead focus on creating a project management office to coordinate and oversee IT projects in the departments, standardizing hardware and software to the extent possible, working with departments to improve current operational systems, developing policies and procedures for sharing data among departments, and developing a management reporting system (integrating summary level data). These objectives need to be clearly developed in the IT master plan that the Ministry is in the process of preparing.

Even though the MoF has made significant progress automating operations in the separate departments, there are still some gaps and deficiencies in their systems. The most obvious gap is the lack of budget preparation/planning software. The budget is currently prepared using Excel spreadsheets, and then budget data is re-keyed into the treasury system for budget execution. This is a very inefficient method for preparing the budget and is prone to data entry errors. The MoF needs a proper budget preparation/planning system. Another key deficiency is poor quality expenditure data, which indicates flaws and limitations of the treasury system. The Treasury Department developed the treasury system in-house with input from foreign technical advisors, but it appears that there was not sufficient quality control during the software development process. Correcting problems in the software could take years with potentially limited success. The last main deficiency is the difficulty of sharing and integrating data among the different operational systems in the Ministry departments. In some cases, there are not data communications links between the different departments to facilitate data transfer, but even when there are links, data is not efficiently uploaded to integrate data seamlessly without IT staff intervention. Resolving these issues presents a significant challenge to the MoF, and the staff and IT equipment required to resolve them are not currently available.

In other areas of budget execution, the Ministry of Finance and its two key subordinate departments—the Treasury Department and Budget Department—are operating under the following conditions:

- The use of mobile phones to receive Treasury information from the regions, a situation that is necessitated by the lack of any means of transmitting information between Tbilisi and the regions;
- An accounting structure that needs to be upgraded to GFS 2001 standards;
- A method of producing monthly reports that are reasonably up-to-date in the case of ordinary operating expenses but 2-3 months behind in salary expenses, and which do not match the budget structure in format;
- A system of payroll distribution that relies on lump-sum wire transfers from the Treasury to banks (without any tracking mechanism to the employee level) in the case of Tbilisi-based employees, and which is cash-based and manual in the case of the regions and schools outside on Tbilisi; and
- No systems of routine audit trails, asset management or inventory management.

The Treasury has made progress in a number of areas in the past few years. It is in the process of consolidating revenue accounts to a manageable number; it appears to be on track with creating a Single Treasury Account by the legislated deadline of January 1, 2006; it is working with the help of an IMF advisor to create a new Chart of Accounts and make the migration to GFS 2001 accounting standards; and it has brought all entities in the budget under the Commitment control system, including the extra-budgetary funds (Road Fund, Pension Fund) that were incorporated into the State budget in the current year.

Recommendations

The Government is well positioned to make significant strides to upgrade its financial management structure in the near-term. The legal framework defines and mandates the fundamental components of reform, leadership is open to creative ideas, and the organizational culture allows for significant changes in staffing levels and assignments. As an added impetus, the likelihood of significant assistance through the Millennium Challenge Georgia Fund compact creates the need for a greatly enhanced financial management capability within the Government (the MoF) so that it can serve as a qualified "Fiscal Agent" for the purposes of managing the Fund. Thus, the following areas of assistance would be most useful in the next 2-3 years:

- ***Help the Government implement a world-class financial management information system (FMIS).*** A suitable FMIS would provide all the functionality required by the Ministry, have robust data entry controls, and integrate data from key sources into one database. Implementing a packaged FMIS can be accomplished in a relatively short period of time and with a lesser commitment of IT resources than would be the case with an internally developed system. The FMIS should include the core financial modules (general ledger/chart of accounts, appropriation/budget release control, expenditure management and payment processing, statutory and management reporting, and audit trail), and should include the capability to phase-in other modules at a later date (HR/payroll, purchasing, asset management, and stock/inventory management). Implementing an FMIS would provide numerous benefits to the Government and its ministries:

- On-line access for all spending institutions
 - Fully integrated financial functions—significant efficiencies for all institutions
 - The opportunity to undertake business process reengineering (BPR) to streamline government procedures and reduce administrative costs
 - Effective implementation of new accounting standards—Chart of Accounts, GFS 2001
 - Reporting capabilities and Parliamentary oversight
 - Enhanced audit and control capabilities
 - Capability for the Government to assume MCC fiscal agent responsibilities
 - Enhanced quality and reliability of financial data
 - Provision of one of the key tools for transparency and anti-corruption efforts in Georgia
- ***Restructure operations for pension distribution and accounting*** in support of Government pension reform initiative. This would allow the government to direct the distribution of pension payments directly to the individual recipients, providing for more secure monetary transmissions, fewer opportunities for “leakage” of funds, and better tracking and reporting capabilities.
 - ***Upgrade communications between center and regional treasuries.*** This will allow for much more secure, accurate and timely information flows across the Government, and allow for secure and timely monetary transfers from the center to the regions and localities.

With regard to the first recommendation, the full benefits of FMIS implementation can be realized only if business process reengineering is included as a fundamental component of the initiative. It is not useful to automate processes that are not necessary, or to simply replace all manual activities with automated activities. The MoF and key ministries should use the investment in FMIS as an opportunity to re-think and restructure how they carry out the daily functions of governance and financial management.

A major implementation issue is that of training of users on the new system. The MOF’s IT Department does not have the capability to develop a full FMIS, and it should concentrate its limited resources on more productive purposes, such as system security and technical support, and ensuring that all systems users—including those from other ministries—are properly trained in system use.

3.3. Internal Audit

Current Situation

The Organic Budget Law provides a good legal framework for the conduct of the Internal Audit function. It mandates an Internal Audit function for all spending institutions, autonomous regions and localities. Consistent with international practices, it gives the Ministry of Finance the lead oversight and coordinating role in the executive branch. Article 28 of the Law states that the “Minister shall.....coordinate, in concord with the Chamber of Control of Georgia, the accounting control and internal audit and issues relevant to legislative acts.”

At the present time, the Internal Audit function (referred to as the Inspector General, or IG) is not being given a high priority as a reform item in the Ministry of Finance. The IG organization was greatly downsized in the first half of 2004, from six to three divisions and from 75 to 21 employees. That move in itself may have been a credible way to streamline the office and make it more efficient. There is, in fact, anecdotal evidence from interviews with MoF staff that the former office was not necessarily operated efficiently and may not have been as effective as it should be. But what does seem clear is that re-building an effective Internal Audit function is not as high on the list of priorities as some other initiatives at this time.

In the spending ministries, the Internal Audit function is present in most cases. And in connection with the spate of reorganizations that have occurred and that are still in process in many ministries, this function seems to be surviving in the new organizational charts. But it appears that the importance of the function and the levels of proficiency vary from ministry to ministry. In some cases (e.g., the Ministry of Education), the Internal Audit unit performs *performance* audits as well as the fundamental financial audits. This would be necessary due to the issue of school accreditation standards. But in most cases, the IA units are focused on financial audits. Even with financial audits, however, the level of proficiency may vary from case to case. The Ministry of Education, for example, tendered a 9-month contract to a private firm in 2004 to review the operations and performance of the IG, for the purpose of obtaining an impartial and full view of the unit's operations including the exploration of allegations of improprieties.

It appears that a common theme throughout the ministries is that of uncertainty about the future role of the Internal Audit function or perhaps an evolution of thinking about its role in government. At the same time, there seems to be a general lack of understanding about how this function can be used in a non-partial, transparent fashion to help ensure the integrity of financial management and daily governance, as well as serve as an important information link to the Government's Supreme Audit Institution—the Chamber of Control.

Recommendations

Recognizing that the Government ministries and the Ministry of Finance in particular (with its oversight role) seem to be re-defining the role that the Internal Audit function should play in financial management and governance, the immediate areas of assistance could be as follows:

- ***Help educate the Ministry of Finance and other Ministries*** on the important role that Internal Audit should play in the Government financial management and the daily governance of complex organizations;

- ***Assist the Ministry of Finance to develop its Internal Audit unit*** in a way that will:
 - Serve as an effective tool in ensuring the financial integrity of the Ministry,
 - Help chart its legal responsibilities in government-wide coordination and oversight; and
 - Assist in defining the proper procedures and protocols to follow in its role as the primary conduit between the executive branch Ministries and the Chamber of Control
- ***Develop the institutional capacity of Internal Audit units*** in all key ministries, and to develop their capacity to conduct the function at defined international standards.

4. PENSION REFORM

4.1. Structure of Pension

4.1.1. Public Pensions

Current Situation

In the past, the major fiscal (and social) problem for the public pension system was arrears in payments. At the beginning of 2004, pension arrears totaled approximately 130 million GEL (about 1.3% of GDP). However, increased tax collections in 2004 and other factors, permitted about 84 million GEL in arrears to be cleared. The SUSIF expects that all arrears will be cleared by the second quarter of 2005 and does not expect a recurrence of the arrears problem in the near future.

The doubling of basic labor and social pension benefits and the reduction in the social tax rate may have some negative implications for the fiscal health of the Georgia budget. It should be noted that in a number of meetings the assessment team determined that analysis of the fiscal implications of the changes made in 2004 for 2005 and beyond, had not been conducted. The estimates presented below are based on revenue and expenditure estimates provided by the SUSIF and the MoF and some extrapolations from previous year data. They should be considered as reasonable estimates, but subject to the underlying accuracy of the data provided.

For 2005, we estimate the cost of increasing the basic pension benefit from 14 to 28 GEL per month at about GEL 115 – 125m (based on budget data and the estimated number of beneficiaries receiving the increased basic benefit) assuming that the number of beneficiaries remained relatively stable and the number of privileged pensions does not increase significantly. While this should be a reasonable

assumption, the re-registration of all pensioners that is currently underway, could affect this assumption.⁵

According to the Tax Administration, the decrease in social tax collections between 2004 and 2005 is estimated at approximately GEL 100m. Using the share of social contributions that historically would have come from the pension contribution (relative the health and employment contribution), the tax loss would be an estimated GEL 80-85m. Therefore the combined effect of the increased benefit expenditures and reduced social tax revenues would be in the range of GEL 195-210m. This is an estimated 1.8 – 1.9% of GDP based on the most recent IMF GDP estimates for 2005 (not an insignificant fiscal impact). If no changes were made to current law, this impact would likely lessen in future years due to increases in revenue (increase compliance due to the lower tax rate and rising wages) and a benefit level that does not increase. Obviously, if benefit levels were increased on an ad hoc basis, the fiscal implications would need to be estimated.

The relatively robust growth in the economy and generally high revenue growth means that the effects of the pension and social tax changes should not compromise the country's fiscal situation. The main recommendation drawn from these estimates is that the ability to estimate financial impacts of policy changes, particularly in an such as pension that are traditionally one of the largest components of public spending, needs to be improved in both the line ministries and the MoF.

A more fundamental problem is that Georgia currently lacks a bona fide pension system. It is also struggling with setting policies for social protection of the poorest segments of the population and distinguishing this assistance to a pension system tied to labor for participation and contributions. It appears that the Georgian government first wants to tackle the poverty program issues. The assessment team did not review the poverty program options being considered. However, discussion held as part of the assessment indicated that officials were planning to address a number of the important issues in designing a poverty program including the benefit unit (household, family or individual), targeting strategies, appropriate benefit levels relative to the poverty line, and means testing as a mechanism to determine benefit levels and phase out rates as income rises.

Technically, the current structure of the public pension system is as follows.

- Individuals who can demonstrate, through their labor workbooks, at least 5 years of social contributions are entitled to a public pension (labor pension). The retirement age is 60 for women and 65 for men.
- Individuals who cannot demonstrate the required contribution history are entitled to a social pension. The age for receiving this benefit is 65 for women and 70 for men.

⁵ Changes in either of these numbers would affect the share of the 2004 – 2005 increase in the social and labor pension line item attributed to the benefit increase. The estimate above attributes the full amount of the expected increase

- The basic pension is the same for both labor and social pensions. Prior to 2005 it was 14 GEL per month. Changes made in 2004 doubled the basic labor and social pension to 28 GEL per month (approximately \$8 and \$16, respectively).
- Certain privileged categories of persons receive additional pension benefits (e.g., war veterans, the disabled). The amount of privileged pensions was not changed.
- Prior to 2005, social contributions were 33% of gross wage. This comprised 2 % from the employee (1% each for the pension fund and health fund) and 31% for the employer (27% for the pension fund, 4% for the health fund, and 1% for the employment fund). Beginning in 2005, the new social tax is a flat 20% of gross wage payable to the state treasury, rather than the special funds.
- Benefit payments are made through either commercial banks or through the Post Office (often delivered to individuals directly in cash). The percentage of pension payments made through banks has increased dramatically in recent years and GUSIF reports that over 80% of benefits are now made in this way. This improves both the efficiency of the process and reduces errors and corruption.

In reality, there is a very weak link between work history and pension benefits.

- Benefits are not based on contributions, salary or number of years worked (except to demonstrate at least 5 years of contributions)
- Record keeping on employment history is poor so that it is not really possible to check if individuals even have the required 5 years of social contributions.

The very weak link between work history and benefits, combined with recent changes eliminating the special fund status of social contribution (i.e., incorporating social tax payments into the state budget), means that currently Georgia has a system of demigrants to most elderly individuals rather than a public pension system as commonly understood.

Beneficiaries

For 2005, SUSIF estimates that about 860,000 persons will receive a pension benefit. Of this number, 760,000 will receive the basic benefit of 28 GEL/month. Another 100,000 will receive additional amounts though qualifying for a privileged pension. We believe that these numbers exclude some other categories of pensions that are administered by SUSIF such as military and law enforcement.

Revenues

According to the Tax Administration, social contributions for 2003 were GEL 224.8m and for 2004 were GEL 402.2m. For 2005, revenues from the new social tax are estimated at GEL 301.0m. The 2003 and 2004 revenue figures we obtained do not distinguish between social contributions for pension, health and employment funds. Beginning in 2005, the social tax does not have separate rates for these categories.

Expenditure

The table below provided 2004 (actual) and 2005 (estimated) pension benefit expenditures.

Table 3. Pension Expenditures for 2004 and 2005¹

| Category | 2004(actual) Million GEL | 2005 (budget) Million GEL |
|--|--------------------------|---------------------------|
| Total | 303.7 | 348.8 |
| Labor and Social Pensions ² | 184.8 | 306.4 |
| Law Enforcement | 29.4 | 40.0 |
| Regressive Pensions ³ | 1.5 | 2.4 |
| Arrear Payments | 84.0 | 0 ⁵ |
| Court Decision ⁴ | 4.0 | 0 |

1/ Source: Georgian State Unified Social Insurance Foundation Budget

2/ Includes privileged pensions

3/ Reimbursement for health damage caused while fulfilling work

4/ The team was not able to determine the basis for these expenditures during the mission

5/ According to SUSIF, about GEL 46 million in arrears remained at the end of 2004, with no arrears being accumulated. Funds to pay the areas were transferred to the state budget (since SUSIF lost its extra-budgetary status in 2005) and are therefore not reflected in the SUSIF budget.

4.1.2. Private Pensions

Current Situation

Private pensions can be an integral part of the overall pension system in a country. Their primary fiscal impact relates to areas such as:

- Lost tax revenue (when contributions receive a tax preference to encourage contributions);
- The cost of any guarantees that the government may make to protect workers; and
- Potentially lower costs of social assistance and other programs for the elderly to the extent that retirement savings are higher.

In Georgia, the private pension system is in its infancy. Currently there are no tax preferences, very few participants, no state guarantees and any benefits due to increased retirement savings will not materialize for years. Therefore, as part of this fiscal assessment, we only provide a brief overview of the private pension system in Georgia.

Private pension schemes were authorized in 1999. The Georgia Insurance State Supervision Service (ISSS) regulates private pension schemes. ISSS is also responsible for supervision of the private insurance sector. The legislation was developed with assistance from the World Bank. Over the next several years (and continuing today) ISSS developed the various implementing regulations (called normative laws in Georgia) also with some assistance from the Bank.

Under current law, ISSS can license three types of organizations to run pension schemes:

- Private pension funds. Organizations and institutions that can establish pension schemes for their own members/employees. They are required to have minimum capital of GEL 2m of which 80% must be in cash (cash like holdings);
- Private insurance companies. Companies that can establish a pension scheme and invite participants into the plan. They are required to have minimum capital of GEL 1m of which 80% must be in cash;
- Commercial banks. Commercial banks can establish pension schemes similar to those of private insurance companies. They are required to have minimum capital of GEL 5m. This level is set by the National Bank of Georgia, which has regulatory responsibility for the banking system. The level of minimum capital is scheduled to rise to GEL 12m by 2008.

While some regulations are still under development, many of the normal regulations common to international practices have been developed (though the assessment team did not review) including standards for licensing, management of assets, founding capital, reporting requirements and relationship of plan to participants. Though ISSS considers that it has done a good job in developing the legal and regulatory framework for the private pension area, they are concerned that they lack the institutional capacity to effectively supervise the system if it begins to grow.

At present, seven companies are licensed to establish pension schemes. In practice only two are functioning by enrolling or trying to attract members. The first of the two active companies, GPI Holdings, is a private insurance company type. The second, the National Bank of Georgia, has established a private pension fund for its employees.

According to ISSS, licensing and activity in the private pension area picked up dramatically in 2004. However, a change in the tax code (part of the overall changes to the Georgian tax code) in 2004 eliminated the tax preference for pension contributions. This has brought activity in the area to a virtual halt (newly licensed companies are not actively seeking participants according to ISSS). It is unclear if this slow down in activity will remain as long as the tax code stays as it is with respect to private pension contributions. However, in most countries with significant private pension systems, tax preference for pension contributions are given to encourage participation and savings.

Recommendations

- **Consider fundamental pension reform** that links contributions with benefits, provides incentives for retirement savings, etc. and conducting analysis of fiscal impact on any reforms (both short-term and longer-term)
- **Support to the newly formed Working Group charged with streamlining Georgia's pension laws**, with technical assistance provided for two primary purposes:

- Helping to assess the fiscal and social implications of proposed changes to both the pension system and any new poverty benefit. This could have the longer term benefit of improving the analytic capacity of Georgia's relevant agencies;
- Helping to ensure that legislative changes made will be consistent with and help promote (rather than hinder) the longer-range goal of a true pension reform for the country.
- ***Strengthen the institutional capacity of ISSS*** in order to effectively supervise the private pension industry in the following areas:
 - Training in actuarial techniques and conducting examinations;
 - Development of investment regulations;
 - Implementation of financial reporting requirements;
 - Setting standards for accreditation of actuaries;
 - Development of on-site and off-site examination manuals, policies and procedures; and
 - Development of common information technology system to facilitate reporting requirements
- ***Develop a system to track social contributions*** by individual workers to provide an information base that will support a number of objectives:
 - For accurate determination of basic pension eligibility (even under the current system with weak ties to labor force participation);
 - To ensure that public benefits are only paid to those entitled to them; and
 - For accurate determination of benefit levels.

4.2. Contributions and Benefits Administration

Current Situation

Responsibility for the collection of pension contributions was given to the Tax Department several years ago. While it took some time for this function to be fully integrated with the rest of the tax collection, this has now taken place. While these contributions were accounted for separately from the State Budget, the Tax Department did not seem to place as much attention on the administration of these collections as it did for the other core taxes. However, now that these contributions are included in the State Budget, there is an increased incentive for the Tax Department to improve the collection performance of the pension contributions, which did happen last year in conjunction with the overall increase in tax collections. With the reduction in income tax rates and combined social contributions, the opportunity is ripe for increased attention to improving the compliance with these taxes. In fact, improved compliance with these taxes and contributions will be critically important in order to avoid a significant gap between collections and benefits costs under the new pension structure.

The current situation in benefits administration is somewhat in flux and difficult to make judgments about going forward. The SUSIF has administrative responsibility for most aspects of benefit administration, though the legislative changes eliminated the separate extra-budgetary fund administered by SUSIF. Beginning in 2005, the Treasury will make direct payments to beneficiaries from the State budget. However, SUSIF must still determine and maintain eligibility roles, provide the list of individuals to receive benefits to the treasury, address beneficiary issues and complaints, and develop budget estimates. On the other hand, the government's interest in a new poverty program and possible changes to the basic pension laws leaves SUSIF's future administrative responsibilities somewhat ambiguous.

SUSIF has undertaken an ambitious plan this year to re-register all individuals for the social and labor pension program. This is an attempt to purge the roles of ineligible individuals and to make their record more accurate. SUSIF indicate that they had identified 20,000 enterprises with 350,000 individuals during the first part of the re-registration. SUSIF maintains the electronic database in electronic form, though most data has to be keyed in by staff based on paper registration forms.

SUSIF and the Treasury indicate that the vast majority of pension payments are now made directly through the banking system. Some benefits are still made through the Post Office (often hand delivered in cash), which was the way in which most pension benefits were delivered in the past. Officials believe this change has both made the system more efficient and dramatically reduced problems with payments (including corruption and non payment). There is a system in place to return uncollected pension benefits to the treasury, but the assessment team was not able to document the reconciliation process.

Information Technology Support for Benefits Administration

There is a need for enhancements to the level of experience in developing and implementing complex, large-scale systems. This is a common problem found on IT projects in developing countries, characterized by poorly prepared system requirements, a lack of documentation, insufficient training, limited system testing, understaffed technical support, and no formal change control procedures. In these situations, the key counterparts do not manage the software development cycle properly, and the end results suffer. Moreover, IT projects often run into serious problems during implementation, even when the software is developed and works properly. Providing advisory services along with hardware and software is the best way to ensure good results from technical assistance.

At the IT infrastructure level, SUSIF has significant problems. A review of the current data flows illustrates the problems. For the state medical system database, beneficiaries submit forms to their local SUSIF office, and the data is transferred to headquarters by e-mail to be added to the central database at headquarters. Pension forms, on the other hand, are submitted to district offices, transferred to regional offices, entered into basic SQL Server databases at regional offices, forwarded to headquarters, and finally reentered into the central database. Besides the inefficiency of transferring paper forms to regional offices and then headquarters by car, entering pension data into two different databases does not make sense.

Regional offices should not be maintaining their own separate databases. This situation has most likely arisen due to a lack of data communications capabilities.

While the state medical system satisfies SUSIF's requirements, the pensions databases require significant enhancements. Currently, the State United Social Insurance Fund only maintains information on existing pensioners. This is the case even though the law (*"On Introduction of Individual (Personalized) Accounting and Individual Accounts in the System of Mandatory Social Insurance"*) establishes the requirement to maintain pension related information on future beneficiaries. The World Bank funded a project to track information on future beneficiaries, but SUSIF stopped using the system that was developed after the project ended. SUSIF also needs to take a further step and process data in order to calculate benefits for each beneficiary. This is a significant undertaking. The appropriate solution is to combine the two systems tracking current and future beneficiaries into a unified pension database and add the capability to calculate pension benefits for individuals.

In summary, the major problems in benefits administration include:

- The lack of ability to independently verify eligibility for pension benefits. Individuals must produce their labor workbook to show that they have made at least 5 years of contributions to the system. However, the accuracy and veracity of these workbooks cannot be verified by SUSIF. There are many reports that fraudulent workbook can be purchase for a nominal sum. Without a system to track individual's actual contribution (on their behalf by employers) during their working careers, this problem will continue.
- The lack of appropriate information systems that can link centers where individuals register for pensions and the central database;
- Internal information systems at SUSIF are not adequate to run a modern and efficient pension administration system;
- There is a lack of IT compatibility between SUSIF who must register and certify eligibility and the Treasury who must pay benefits in a timely manner.

Recommendations

To ensure proper development and implementation of a new unified pension system, technical assistance should be provided. This assistance should include advisory services and hardware and software to run the system.

- ***Advise counterparts on system design, project management, and system implementation.***
- ***Develop a unified system that would include:***
 - Determining the agency responsible for collecting, storing and analyzing the information;
 - Determining the frequency with which the information should be collected (annually, quarterly, monthly);
 - Determining the specific information to be collected;
 - Setting policies related to unique identification numbers for individuals;

- Determining the systems requirements to support the effort;
 - Defining the policies and procedures and institutional capacity necessary to efficiently administer the system;
 - Define training requirements;
 - Develop an implementation plan, and effect implementation.
- ***Funding support for data communications equipment and*** a commitment from the government to pay communications service fees would facilitate a significant improvement in the SUSIF systems architecture. SUSIF also needs additional servers and PCs to enhance the system architecture.

APPENDICES

1. SUMMARY OF TECHNICAL ASSISTANCE REFORMS

Donor Financing of Structural Reforms – 21 November 2004¹

| Project | Requested Funding | Pledged Funding | Donor | Remarks |
|--|-------------------|-----------------|------------------|---|
| MoF/Central Apparatus | | | | |
| 1. Consolidating MoF in one facility | US\$ 1,800,000 | US\$ 1,800,000 | World Bank | Part of the reallocation of the Structural Reform Support Credit as requested by MoF in letter dated 24 September 2004. |
| 2. IT system Department for Information and Analysis | US\$ 300,000 | US\$ 900,000 | UNDP/Netherlands | WB and US are willing to finance this project. There assistance is proposed to concentrate on other MoF projects. The project will also cover: Financial Police (hardware and training) and Tax Department – Excise, Taxpayers, Inspection, plus some other, not yet defined elements The total project is probably valued at US\$ 900,000, of which US\$ 200,000 will be financed from own sources of MoF. |
| Tax Department | | | | |
| 1. Computerization | US\$ 700,000 | Euro 300,000 | EU/Tacis | Part of Tacis project in Customs/Tax Department, total Euro. 3.0 million. Tax Department is foreseen to be allocated Euro 1.5 million, of which 20% (Euro 0.3 million) can be used for investments. |
| | | US\$ 350,000 | USAID | Possibly part of the Fiscal Reform Project, which is presently being identified by Tim Wellesley. |
| 2. VAT Center | US\$ 100,000 | US\$ 300,000 | World Bank | Part of the reallocation of the Structural Reform Support Credit as requested by MoF in letter dated 24 September |

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| | | | | 2004. The estimation of Tax Department is a total cost of US\$100,000. There is a need to verify this because in MoF letter an amount of US\$ 300,000 is mentioned and WB is willing to allocate this. |
| 3. Enhancement of Tax Department (Training) | Euro 1,200,000 | Euro 1,200,000 | EU/Tacis | Part of Tacis project in Customs/Tax Department, total Euro 3.0 million. Tax Department is foreseen to be allocated Euro 1.5 million, of which 20% (Euro 0.3 million) can be used for investments. |
| 4. Enhancing Excise Taxpayers Inspection | Euro 50,000 | Fully | UNDP/Netherlands | The project will also cover: MoF/Dep. for Information and Analysis and Tax Department - Excise Taxpayers Inspection, plus some other, not yet defined elements The total project is probably valued at US\$ 900,000, of which US\$ 200,000 will be financed from own sources of MoF. |
| Customs Department | | | | |
| 1. Electronic Seal and Satellite Control System | US\$ 330,000 | Euro 300,000 | EU/Tacis | Customs/Tax Department, total Euro 3.0 million. Customs Department is foreseen to be allocated Euro 1.5 million, of which 20% (Euro 0.3 million) can be used for investments. |
| 2. Gardabani Check Point | US\$ 700,000 | US\$ 150,000 | World Bank | Part of the reallocation of the Structural Reform Support Credit as requested by MoF in letter dated 24 September 2004. This concerns only inspection equipment. Funding for other infrastructure is not yet secured. |
| 3. Lagodekhi Check Point | US\$ 350,000 | | | |
| 4. Risk Assessment | Euro 1,200,000 | Euro 1,200,000 | EU/Tacis | Part of Tacis project in Customs/Tax Department, total Euro |

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| | | | | |
|------------------------------------|---------------|-----------------|------------------|---|
| | | | | 3.0 million. Tax Department is foreseen to be allocated Euro 1.5 million, of which 20% (Euro 0.3 million) can be used for investments. |
| 5. Secondary Legislation | | | | |
| Financial Police | | | | |
| 1. Strategic Planning | Not yet known | Not yet known | | Likely the Dutch Financial Police will continue its support in this field. |
| 2. Enhancement of Staff (Training) | Not yet known | Largely | UNDP/Netherlands | <p>The project will also cover: MoF/Dep. of Information and Analysis and Tax Department - Excise Taxpayers Inspection, plus some other, not yet defined elements. The total project is probably valued at US\$ 900,000, of which US\$ 200,000 will be financed from own sources of MoF.</p> <p>The US/Fiscal Reform Project will also provide training. However, because the USA prohibits support to the Financial Police, this will be given as general support for training in Tax Evasion (including also prosecutor's office, judges, tax department).</p> |
| 3. Equipment | Not yet known | To large extent | UNDP/Netherlands | As part of the US\$ 900,000 project, the following will be covered: integration of Financial Police in common database of MoF; establishment of data link with Customs; hardware and software. |

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¹This summary was prepared by Hennie Maters at the request of the Minister of Finance. Coverage or planned activities, level of funding and timing of assistance are all subject to change depending on final decisions by donors.

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Workplan for USAID Georgia Fiscal Reform : October 2004 – September 2005

| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|---|------------------------------|---|--|---|---------------------------------------|
| Task: Technical Assistance to the Ministry of Finance, and Tax Department | | | | | |
| Objective: To Improve Compliance with the Georgian Tax System and Enhance Revenues Through Incentive Programs and Targeted Enforcement. | | | | | |
| Activity A: Assisting the Ministry of Finance and the Tax Department to further improve reorganization through strengthening of Taxpayer Service, Revenue Analysis and the integration of certain tax/customs functions. and automation of the Tax Department. | <u>Oct 04 -Sep 05</u> | | | Improved organizational structures at Ministry and Regional levels, improved operational procedures, improved taxpayer compliance, reduction in corruption, and increased revenues. enhancement of automated system. | |
| 1. Evaluate current organizational structure at the Tax Department, in particular the Large Taxpayer Inspectorate (LTI) and the Excise Tax Inspectorate (ETI). | Nov 04 – Dec 05 | Davies/Crawford: Evaluate current Tax Department operating structure. | Counterpart feedback on current system. | Report on current structure with recommendations for improvement. | Workshops for Department Heads of MSR |
| 2. Develop plan for improvement of organizational structure within the Tax Department and the Ministry, with particular focus on the development of taxpayer service, revenue analysis, and the integration | Dec 04 – Jan 05 | Davies/Crawford: Develop improved organizational structure within the Tax Department, and outline for tax/customs integration | Agree framework for new structure and provide counterpart staff. | Improved organizational structure at the Tax Department, increased tax base, reduction in the shadow economy, | Workshops for Ministry staff. |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|---|-----------------|--|---|---|--|
| of certain tax/customs functions. | | at the Ministry level. | | increased budget revenues. | |
| 3. Prepare a proposed structure with functions for new integrated tax/customs organizational structure at Ministry level. | Nov 04 | Davies: Prepare proposed structure and explanation of functions. | Agree to undertake proposed reorganization. | Recommended structure for integrated tax/customs organization. | |
| 4. Prepare a proposed structure for a new Revenue Analysis Unit within the central office of the Tax Department, the ETI, and the LTI. | Jan 05 – Apr 05 | Davies: Prepare the proposed organization with detailed explanation of function. | Agree to the proposed Revenue Analysis Units. | Revenue Analysis Units. | |
| 5. Selection of personnel and training in risk analysis, selection criteria and targeting of non-compliance for the Risk Analysis Unit. | Apr 05 – Sep 05 | Davies: Identify appropriate training, coordinate and participate in the training event. | Coordinate selection process, Identify personnel and authorize participation in the training process. | Revenue Analysis Units that analyze information from all sources, develop criteria for determining taxpayers at risk for non-compliance, and deliver targeting information to appropriate end user. | |
| 6. Public relations strategy concerning these improvements to the tax system. | Jan 05 – Apr 05 | Project PR Specialist: Prepare strategy, identify and develop relationship | Agree to PR strategy. | Public Relations Strategy document. | World Learning: Workshops for Revenue Analysis Unit personnel. |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|---|-------------------------|---|--|---|---|
| 7. Public relations strategy for the Tax Department concerning the Taxpayer Service function and the provision of taxpayer education workshops. | Feb 05 – Apr 05 | with local media. Project PR Specialist: Prepare strategy, identify and develop relationship with counterparts and local media. | Agree to PR strategy | Public Relations Taxpayer Services Strategy document. | World learning: Train the Trainer workshops. |
| 8. Train the Trainer workshops to introduce the capability for Tax Department Taxpayer Service personnel to develop and conduct taxpayer education programs. | Feb 05 to Jul 05 | Project PR and Training Specialists/Davies: Organize workshops and assist in the delivery, and conduct follow-up analysis to ensure success and sustainability of the program. | Agree to Train the Trainer program, identify training resources, assign training resources to the training course, authorize and support the taxpayer education program. | Qualified Tax Department resources to deliver taxpayer education program in support of the taxpayer service function. | |
| Activity B: Assisting the Tax Department to improve the computerized Taxpayer Information System to support the overall goal of greater taxpayer compliance and improved revenue performance by providing for analysis of data for risk assessment, the reduction in the | Oct 04 - July 05 | | | Enhanced revenues due to improved taxpayer compliance through the introduction of modern, automated enforcement capabilities and the simplification of the administrative process. | |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|---|-----------------|---|---|--|---------------------------|
| administrative burden for compliant taxpayers, improved processing of tax returns, information exchange between revenue agencies, and direct trader/taxpayer input through e-filing. | | | | | |
| 1. Evaluate use and level of automation, and the current status of the automated Taxpayer Information System within the Tax Department, the LTI and the ETI. | Nov 04 – Mar 05 | Yates/Davies/Kacharava: Conduct needs analysis for hardware and software improvements for the Tax Department. | Counterpart input on requirements. | Report on IT needs analysis. | |
| 2. Develop IT hardware and software development/improvement strategy for the Tax Department. | Nov 04 – Mar 05 | Yates/Kacharava: Develop strategy plan for IT. | Agree IT strategy plan. | Strategy Plan for IT improvements for Tax Department. | |
| 3. Develop pilot project for direct, online submission of required documentation by taxpayers to the ETI. | Dec 04 – Jan 05 | Davies/Yates: Develop Functional Specifications. | Agree Functional Specifications. | Written Functional Specifications for use by the developers. | |
| 4. Develop secure, web 'portal' for the ETI that will allow excise taxpayers to directly access the ETI website on the internet and complete and submit required documentation | Jan 05 – Sep 05 | Kacharava: Coordinate and assist in the development process. | Provide space at the ETI and IT specialists to assist in the development process. | ETI secure web portal, timely submission of documents directly by taxpayers, capability for automated risk analysis. | Local website developers. |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|--|-----------------|---|--|--|--------------------|
| 5. Develop database that can interface with the web-based application for receipt and storage of documentation submitted via the ETI portal. | Jan 05 – Sep 05 | Kacharava: Coordinate and assist in the development process. | Provide space at the ETI and IT specialists to assist in the development process. | ETI database that stores directly submitted data that is accessible by the Revenue Analysis Unit. | Local developers. |
| 6. Procurement for IT hardware requirements for Tax Department, LTI and ETI pilot project. | Oct 01 – Mar 05 | Yates/Davies: Complete RFP procedure. | Counterparts provide input to hardware specifications. | Procurement of sufficient hardware in accordance with the IT strategy and ETI pilot project needs. | |
| 7. Develop new operational procedures for ETI web portal and provide training in these new operational procedures and software utilization. | May 05 – Sep 05 | Davies/Kacharava/Project Training Specialist: Training plan, assist in delivery of workshops. | All counterpart operational staff trained. | Training in new operational procedures and software use. | |
| 8. Implementation of recommended software development/improvements | Feb 05 – Sep 05 | Kacharava: Software development/improvement. | Counterparts provide IT specialist resources and significant input to software specifications. | Software developed/improved. | |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|--|-----------------|---|---|--|---|
| | | | | | |
| Activity C: Assisting the Ministry of Finance with training to further develop and improve the capacity of departments and staff to understand and administer the tax laws as they relate to tax evasion. | Jan 05 – Sep 05 | | | Establishment of an effective program for addressing tax evasion involving the tax department, and the judicial/court system. | |
| 1. Conduct and analysis of the policies and procedures in place within the Tax Department for identifying and taking action against various forms of tax evasion. | Jan 05 - Mar 05 | Project Legal Specialist: Conduct analysis and develop recommendations. | Ministry to provide access to personnel and written procedures for evaluation. | Report on current policies and procedures with recommendations for improvement. | |
| 2. Conduct and evaluation of the administrative and criminal sanctions that are currently in place to address tax evasion. | Jan 05 - Mar 05 | Project Legal Specialist: Conduct analysis and develop recommendations. | Ministry to provide access to personnel and assistance in gaining access to other specialists such as prosecutors and the | Report on findings with recommendations for improvements. | Interviews with judiciary, prosecutors office and other stakeholders. |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|--|------------------------|---|--|---|---|
| 3. Design, development and delivery of comprehensive training for complete cross-section of personnel responsible for detecting, identifying, investigating and prosecuting tax evasion. | Jan 05 – Apr 05 | Wellesley: Design and then conduct training with appropriate counterparts as identified in training plan. | judiciary. Agree on to training plan, agree to selection and provision of appropriate personnel, and agree to follow-up activities. | Staff training | Involvement of personnel from other government departments. |
| 4. Identify appropriate follow-up activities to ensure sustainability of training objectives, such as new policies and procedural manuals, train-the-trainers courses, and legal amendments. | Mar 05–Sep 05 | Davies/Wellesley/Project Legal Specialist: Preparation of program for follow-up activities. | Ministry to nominate training personnel to act as trainers and to assist in the preparation or amendment of manuals. | On-going training program, new policy and procedures. | Involvement of personnel from other government departments. |
| Activity D: Assisting the Ministry of Finance to develop commentary explaining the newly implemented Tax Code. | Feb 05 – Sep 05 | | | Commentary is prepared and utilized by tax officials to assist in the preparation of explanatory material to taxpayers through the newly organized Taxpayer Service Units. | |
| 1. Review and evaluate the newly implemented Tax Code particularly with | Feb 05 – Jul 05 | Sweeting/Project Legal Specialist/Davies: Identify | Approve process. | | |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|---|-----------------|---|---|--|--|
| regard to the accounting provisions, arrears collection and procedures, audit authorities, information exchange, and appeals. | | key provisions requiring commentary and clarification. | | | |
| 2. Prepare commentary and white/issue papers on specific issues. | Feb 05 – Sep 05 | Sweeting/Project Legal Specialist/Davies: Preparation of commentary, white/issue papers. | Consider and approve commentary and white/issue papers. | Draft commentary and other explanatory material. | Workshops. |
| 3. Establish list of immediate public educational publications required | Mar 05 | Sweeting/Project Public Relations Specialist: Reach agreement with Ministry on public educational requirements. | Agree educational publications requirements. | Prioritized list of subject matter | Business Foundation, AMCHAM participation. |
| 4. Agree final draft of commentary after consultation with all interested Ministries and business groups. | Mar 05 – Apr 05 | Sweeting/Project Public Relations Specialist: Consult and obtain agreement on final draft of commentary. | Participate in consultation and agree draft. | Agreed final draft of commentary. | Business Foundation, AMCHAM participation. |
| 5. Develop and submit proposals for legislative change to the new Tax Code for enactment in 2006. | Apr 05 – Sep05 | Project Legal Specialist/Davies: Preparation of list of recommended Tax Code amendments. | Prepare and submit legislative changes | 2006 draft Tax Coded amendments. | |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|---|-----------------|---|--|---|---|
| Activity E: Assisting the Ministry to improve its revenue data collection and reporting procedures, to ensure this information is prepared in a more timely and accurate fashion and accessible as an effective management tool. | Nov 04 – Sep 05 | | | Accurate, timely revenue performance reporting, and a more effective internal management controls. | |
| 1. Identify key sources of data within the various Departments in the Ministry and arrange for Ministerial authority to access this data. | Dec 04 | Project Economist: Prepare authorization and obtain Ministerial consent. | Ministry Departments to provide data in accordance with the authorization. | Agreed access to data. | |
| 2. Prepare new, improved revenue performance reporting format that is comprehensive and that is compatible with the requirements of the Ministry Tax Policy Unit requirements. | Dec 04 – Mar 05 | Project Economist: Prepare format, complete with revenue performance data. | Agree format. | Improved Revenue Performance reporting. | Produced in cooperation with the EU Revenue Forecasting and Modeling Project currently in place in the Ministry of Finance. |
| 3. Prepare monthly Revenue Performance Report. | Dec 04 – Sep 05 | Project Economist: Prepare monthly report. | Assign staff to assist in the preparation of the report. | Monthly report and capacity within the Ministry to continue with this key | Produced in cooperation with the EU Revenue |

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| Objectives and Activities | Time Span | Team Member Responsibilities | Counterpart Responsibilities | Deliverables/Results | External Resources |
|--|-----------------|--|---|---|--|
| 4. Improve the automated reporting function of the Tax Information System to support the improved data initiative in support of monthly revenue performance reporting. | Jan 05 - May 05 | Project Economist: Identify reports required from the computerized system. | Provide access to Tax Information System and agree new reports. | Improved automated reporting of revenue statistics. | Forecasting and Modeling Project currently in place in the Ministry of Finance. |
| 5. Improved revenue forecasting and modeling at the Ministry of Finance. | Dec 04 – Sep 05 | Project Economist: Work closely with the EU Project currently providing assistance to the Ministerial Tax policy unit to improve models and data | Provide staff and resources to work with both Projects and agree to improvements. | Improved forecasting, improved GDP estimation, improved revenue performance indicators. | In cooperation with the EU Revenue Forecasting and Modeling Project currently in place in the Ministry of Finance. |

2. RECENT CHANGES IN TAX PROVISIONS IN THE NEW TAX CODE

| Changes made | Earlier provision | Comments |
|---|---|--|
| <p>1. Number of taxes reduced from 21 to 8:</p> <ul style="list-style-type: none"> – Personal Income Tax, Profit Tax, VAT, Excise, Social Tax, Property Tax, Tax on Gambling | Road Fund Tax, Tax on Use of Natural Resources, Tax on Pollution, Tax on Property Transfer, Tax on Small Business, Tax on Import of Cars, Tax on Weight Infringement, Tax on Ownership of Automobiles, etc. abolished | The reduction in the number of 'nuisance' taxes has reduced administrative costs so that the Tax Department can focus on the main taxes; it has also made the tax regime simpler and, hence, reduced compliance costs for taxpayers. |
| <p>2. Social tax is a single tax levied at the rate of 20% of the wage income on the employer.</p> | Employers had to pay a total of 31% of wage income as contributions to several funds (United State Social Insurance Fund, Health Fund, Employment Fund etc.) and employees had to pay 2% of wages. | <ul style="list-style-type: none"> – Reduced the tax burden on wage income; – Provides incentive to declared wages in the formal sector; – Simplifies the tax regime by levying a single tax instead of numerous separate contributions – Removes non-transparent off-budget funds |
| <p>3. VAT rate reduced from 20% to 18%</p> <p>Number of exemptions reduced</p> <p>Single threshold of 100,000 GEL</p> | <p>Earlier there were 33 separate categories of exemption; this has been reduced to about 10.</p> <p>There were two thresholds of 75,000 and 100,000</p> | <p>Base has been broadened and the removal of exemptions has made the VAT regime simpler and less likely for misuse and fraud.</p> <p>The reduced rate to 18% is at the low end in transition economies (Azerbaijan and Macedonia have 18%, Kosovo has 15%) – this is expected to improve showing sales in the formal sector; it will also make the Georgian tax regime competitive in the region.</p> |
| <p>4. VAT refund accounting and payment moved to the Treasury</p> | Earlier this was done by the Tax Department | Removes one avenue for corruption |
| <p>5. Personal Income Tax (PIT) changed to a flat rate tax of 12%</p> | Earlier there were several rates with a minimum rate of 12% and a top marginal rate of 20%. The top marginal rate was aligned to the 20% rate for profit tax (as is typical) | <p>A single rate makes the tax regime simpler but also loses the progressivity that most PIT systems have.</p> <p>The big difference between a rate of 12% and the profit tax rate of</p> |

| | | |
|---|---|--|
| | | 20% will encourage transfer of income from companies to individuals to legally avoid taxes. |
| 6. Exemption threshold in PIT removed | There was a personal exemption threshold of 3,000 GEL | Removing the personal exemption is harsh on the very poor (subsistence) taxpayers, and is administratively a nightmare, since every citizen becomes liable to tax |
| 7. Profit tax rate maintained at 20%. Number of exemptions reduced, depreciation allowance rationalized, thin capitalization rule introduced, and several ambiguities clarified | | Rules following international best practices used |
| 8. Excise taxes alcohol, tobacco, petroleum products and automobiles raised. | Earlier the excise rates were low by regional standards and gave rise to large-scale smuggling. | There will be about a 95% increase in revenue from excise, which will compensate some of the loss from rate reduction in other taxes. |
| 9. Excise rate on automobiles kept specific, based on engine capacity and age of car, rather than ad valorem | | Typically for cars, ad valorem rates should be applied since, for the same engine capacity, the value of the car may differ considerably. |
| 10. Property Tax and land tax integrated – although at the initial stage, the calculation for land and real estate is still presumptive; property tax levied on both enterprises and individuals; also levied on automobiles, yachts, planes and helicopters. | Earlier land tax and property tax were separate. | The old soviet-style tax on book value of all assets of enterprises continues. |
| 11. There is an income threshold; property tax is not charged on house owners having annual income less than 40,000 laris. There are differentiated rates for different income brackets. | There was no threshold | The threshold and taxation at different rates for income brackets exempts people with large properties but with income less than 40,000 laris; prevents the development of the property market |
| 12. The new law on tax amnesty prohibits audit of natural and legal persons who had not declared their income prior to | | Typically, only the interest and penalties and prosecutions are waived, but the undisclosed income |

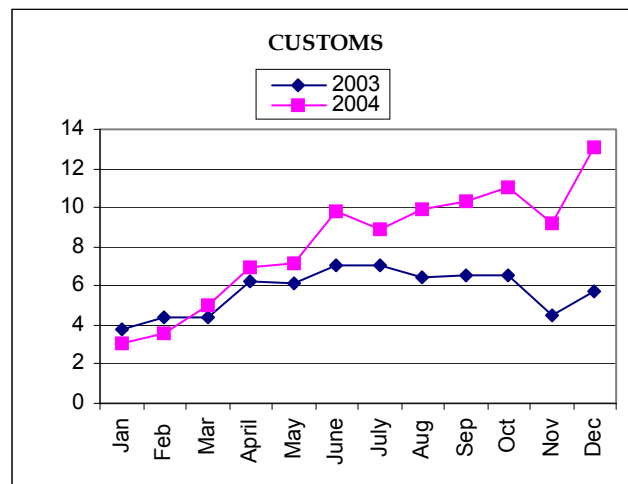
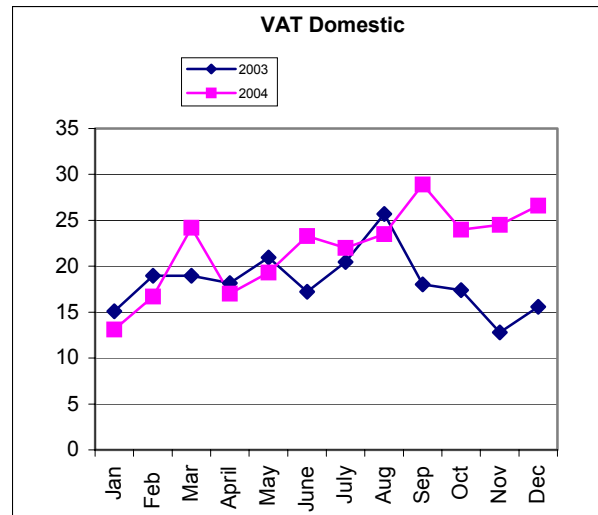
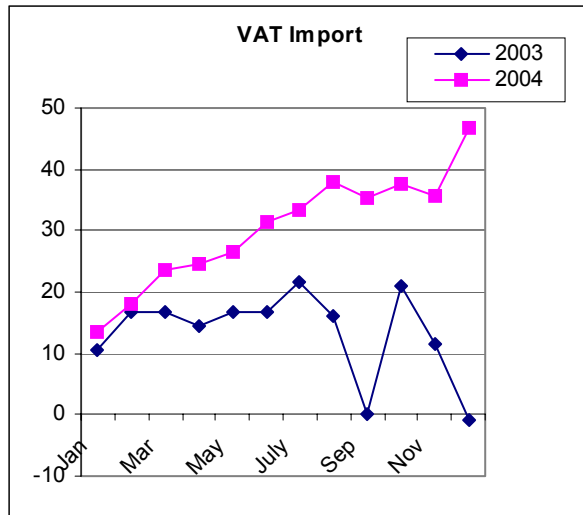
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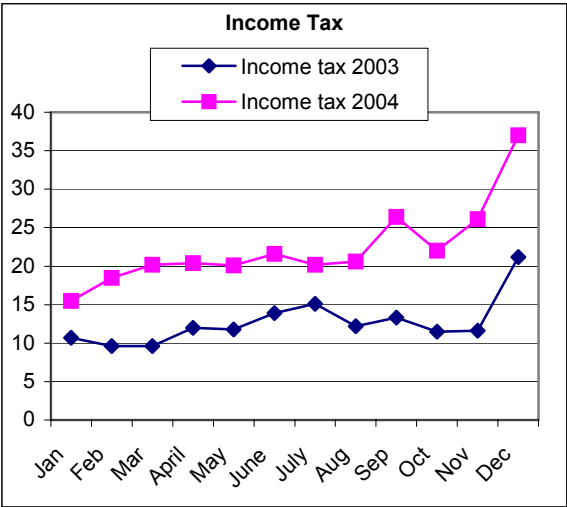
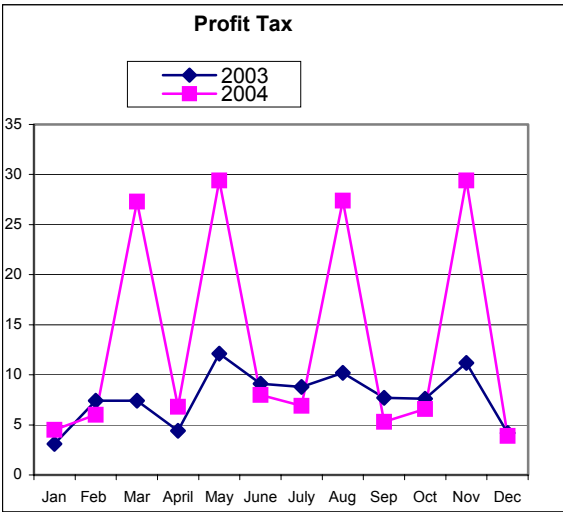
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January 2004. Undisclosed income will be legalized on payment of a token tax of 1%

is taxed at the normal rate. Not taxing this is a discouragement for voluntary compliance by honest taxpayers.

3. REVENUE TRENDS IN 2003 AND 2004 FOR VAT, INCOME TAX, PROFIT TAX AND CUSTOMS





4. MINISTRY OF FINANCE'S ESTIMATE OF IT NEEDS

Ministry of Finance

| N | Item/Specification | Qty. |
|---|---|------|
| Hardware | | |
| 1 | DATA-server: 4 processor XEON 3.2, DDR 8Gb/3200, RAID 5, HDD 240Gb, Streamer | 1 |
| 2 | BACKUP- server: 2 processor XEON 3.2, DDR 2Gb/3200, RAID 5, HDD 120Gb, Streamer | 1 |
| 3 | WEB- server: 2 processor XEON 2.7, DDR 4Gb/3200, RAID 5, HDD 120Gb, Streamer | 1 |
| 4 | Workstation – professional: CPU P4 3.0/800/1024, DDR 512Mb/3200, HDD 80Gb/7200 | 10 |
| 5 | Workstation - operator CPU P4 2.0E/533, DDR 512Mb/3200, HDD 40Gb/7200 | 130 |
| 6 | Notebook | 12 |
| 7 | UPS-for servers 4000 va | 4 |
| 8 | UPS 650 va | 140 |
| 9 | Modem | 6 |
| 10 | Server board | 1 |
| 11 | Network printer HP 4200 | 20 |
| 12 | Laser printer | 40 |
| 13 | Colour printer | 1 |
| 14 | Scanner | 1 |
| 15 | Flash Disk 1Gb | 5 |
| Creation of Integrated Communication Network | | |
| 1 | Connection of MoF-Agencies' LANs' with WAN of MoF | |

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Tax Department

| N | Item/Specification | Qty. |
|----|--|------|
| | Hardware | |
| 1 | Cluster server | 1 |
| 2 | Web-server | 1 |
| 3 | Workstation CPU P4 2.0E/533, DDR 512Mb/3200, HDD 40Gb/7200 | 51 |
| 4 | UPS | 19 |
| 5 | Printer | 22 |
| 6 | Network printer HP 4200 | 5 |
| 7 | Current generator (7 kw) | 2 |
| 8 | Network device (Hub) | 4 |
| 9 | Network device (Switch) | 3 |
| 10 | Network device (Switch) Cisco | 1 |

Customs Department

| N | Item/Specification | Qty. |
|---|---|------|
| | Hardware | |
| 1 | Current generator | 20 |
| 2 | Work station - CPU P4 2.0E/533, DDR 512Mb/3200, HDD 40Gb/7200 | 40 |
| 3 | 4 Processor server | 4 |
| 4 | DVD/RW | 10 |
| 5 | HP LaserJet 1300 | 40 |
| 6 | Flash Disk 1Gb | 20 |

Financial Police

| N | Item/Specification | Qty. |
|----------|---|-------------|
| | Hardware | |
| 1 | 2 Processor server | 1 |
| 2 | Work station - CPU P4 2.0E/533, DDR 512Mb/3200, HDD 40Gb/7200 | 40 |
| 3 | Printer | 25 |
| 4 | UPS | 40 |
| 5 | DVD/RW | 1 |
| 6 | Colour printer | 1 |
| 7 | Flash Disk 1Gb | 3 |

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Calculation Pro Forma for the Connection of Non-Connected Inspectorates in the Global Tax Computer Network

| | | Price per Unit \$ | Quantity | | | Amount \$ | | | |
|--|---|-------------------|---|--------|--------|-----------|---------|---------|-----------|
| | Dimention | | Type A | Type B | Type C | Type A | Type B | Type C | Total |
| Computerization Expences for each Inspectorate | | | | | | | | | |
| Hardware | | | | | | | | | |
| 1 Server | Unit | 5,000 | 1 | 1 | | 5,000 | 5,000 | - | |
| 2 Personal Computer | Unit | 1,200 | 15 | 15 | 1 | 18,000 | 18,000 | 1,200 | |
| 3 Big UPS | Unit | 700 | 4 | 4 | | 2,800 | 2,800 | - | |
| 4 Small UPS | Unit | 170 | 7 | 7 | 1 | 1,190 | 1,190 | 170 | |
| 5 Printer | Unit | 400 | 2 | 2 | 1 | 800 | 800 | 400 | |
| 6 Network Printer | Unit | 1,000 | 2 | 2 | | 2,000 | 2,000 | - | |
| 7 Power Generator, 10 kwt | Unit | 1,500 | 1 | 1 | 1 | 1,500 | 1,500 | 1,500 | |
| 8 Electricity Supply Stabilizator, 7 kwt | Unit | 500 | 1 | 1 | 1 | 500 | 500 | 500 | |
| 9 Network Hub | Unit | 500 | 2 | 2 | | 1,000 | 1,000 | - | |
| 10 Cables and Junctions | Point | 15 | 25 | 25 | | 375 | 375 | - | |
| 11 Raceways and Nails | Point | 20 | 25 | 25 | | 500 | 500 | - | |
| Hardware Total | | | | | | 33,665 | 33,665 | 3,770 | |
| Software | | | | | | | | | |
| 12 Licenced System Win2000 | Unit | 210 | 15 | 15 | 1 | 3,150 | 3,150 | 210 | |
| 13 Licenced "Office" | Unit | 750 | 15 | 15 | 1 | 11,250 | 11,250 | 750 | |
| 14 Licenced Antivirus | Unit | 1,000 | 1 | 1 | 1 | 1,000 | 1,000 | 1,000 | |
| Software Total | | | | | | 15,400 | 15,400 | 1,960 | |
| 15 Works to be done: Network montage | Point | 20 | 25 | 25 | | 500 | 500 | - | |
| Computerization Expences for each Inspectorate | | | | | | 49,565 | 49,565 | 5,730 | |
| | | | | | | | | | |
| Computerization for Inspectorates | | | | | | | | | |
| 1 Computerization Expences for Type A | Amount of inspecorates to be computerized | 49,565 | 4 | | | 198,260 | | | 198,260 |
| 2 Computerization Expences for Type B | | 49,565 | | 15 | | | 743,475 | | 743,475 |
| 3 Computerization Expences for Type C | | 5,730 | | | 40 | | | 229,200 | 229,200 |
| 4 Training and Education of the staff | | | | | | 200 | 200 | 50 | 450 |
| 5 Transportation costs (approx. 300km) | | 100 | 4 | 15 | 40 | 400 | 1,500 | 4,000 | 5,900 |
| 6 Business trip costs (5 people for 5 days) | | 200 | 4 | 15 | 40 | 800 | 3,000 | 8,000 | 11,800 |
| Total investment expences | | | | | | 199,660 | 748,175 | 241,250 | 1,189,085 |
| | | | | | | | | | |
| | | | | | | | | | |
| 1 Approximate annual capital expences for upgrading and updating | \$237,817 | | 20% Hardware and Software support | | | | | | |
| 2 Annual operating expences for the global network service | \$200,000 | | according to the contract by the operator | | | | | | |

5. MEETING SCHEDULE: JANUARY 31 – FEBRUARY 11, 2005

| | | |
|-----------------------------------|---|---|
| January 31, 2005 Monday | | |
| 1. Tax Department | Zaza Kobulashvili, | 1 st Deputy Chairman |
| February 1, 2005 Tuesday | | |
| 1. IMF | Robert Christiansen | |
| 2. MoLHSA | Vakhtang Megrelishvili | Deputy Minister, Social Affairs |
| 3. MoF | Peter Griffin | EU Advisor at the MoF |
| 4. MoF | Hennie Maters | Minister's Advisor |
| February 2, 2005 Wednesday | | |
| 1. MoF | Grigol Gobejushvili | Deputy Minister, Budget |
| 2. SUSIF | Zaza Sopromadze | Head of Foundation |
| 3. MoF | Zurab Antelidze | Deputy Minister |
| 4. Treasury | George Tabuashvili Nino Tchelishvili | Head of Treasury Deputy Head of Treasury |
| 5. World Bank | Anita Schwarz | Mission Head, Social |
| February 3, 2005 Thursday | | |
| 1. Tax Department | Zaza Kobulashvili | Deputy Head |
| 2. Tax Department | Vano Omiadze | IT Department |
| 3. EU | Richard Lax | Task Manager (Customs) |
| February 4, 2005 Friday | | |
| 1. Young Economists Association | David Narmania | Deputy Chairman of Board |
| 2. Parliament Budget Committee | Roman Gotsiridze | Chairman |
| 3. Ministry of Environment | Eka Egiberidze | Deputy Minister |
| 4. GISS | Archil Tsertsvadze | Head of the Service |
| February 7, 2005 | | |
| 1. Tax Department | Zaza Kobulashvili | Deputy Chairman |
| 2. Ministry of Education | Temur Samadashvili | Deputy Minister |
| 3. Customs Department | Vakhtang Lashkaradze | Head, IT Department |
| 4. Financial Police | Dato Kezerashvili | Head |
| February 8, 2005 | | |
| 1. MoF | Grigol Gobejishvili | Deputy Minister, Budget |
| 2. Statistics Department | Teimuraz Beridze | Chairman |
| 3. Ministry of Economy | Vaja Petriashvili | Deputy Minister |
| 4. Ministry of Agriculture | Michael Svimonishvili | Minister |
| February 9, 2005 Wednesday | | |
| 1. Ministry of Economy | Natia Turnava | First Deputy Minister |
| 2. SUSIF | Lado Gigauri | IT Head |
| 3. EU | Maria Iarrera | Project Manager (Tax) |
| 4. Ex-IG | Koba Abuladze | MoF Legal Department Head |
| 5. Department of Road | Roman Dalakishvili | Chairman |
| February 10, 2005 Thursday | | |
| 1. Ministry of Justice | Eka Gureshidze | 1 st Deputy Minister |
| 2. MCG | Lasha Shanidze | CEO |